

## Unholy compromise in the eurozone and how to right it

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Two years after the first Greek rescue in May 2010, crisis management in the eurozone has still failed to restore confidence. A vivid picture of the situation can be found in Figure 1: the constellation of spreads on ten-year sovereign debts over the Bund in the eurozone is wider than it was before monetary union, as though financial markets had already discounted its breakdown. Temporary respites, notably in the early part of 2012, have not interrupted the trend of increasing divergence that risks undermining the credibility of adjustment efforts under way.

Doubts about the sustainability of sovereign debts have been fed by a vicious spiral of potential liabilities swelling sovereign debts from banking rescues. Spreads on sovereign borrowings are widening close to the point of self-fulfilling dynamic instability. Investors from third countries have withdrawn in droves, private capital flows from the core to the periphery have dried up and banking and financial markets are segmenting along national lines. Much of the burden of financing payment imbalances and keeping credit channels open is falling on the ECB.

Once again, the European Council and the euro area summit met in an emergency session, this

time at the end of June, amid acute tensions in financial markets and the eurozone economy in recession and actually plummeting in its southern periphery. Their deliberations – as on many previous occasions – represent progress towards a shared view of the crisis, and have outlined a set of further policies that serve as bricks for a stronger house. But the details have yet to be agreed upon and the usual cacophony of post-meeting contradictory statements has already dissipated some of its positive effects on market sentiment. The latest timid reduction in policy rates by the ECB appears insufficient to ease strained liquidity and credit conditions and help the economy – and has been seen as confirmation that the ECB is acting under unduly tight political constraints.

This paper reviews the causes of the ongoing crisis and the policies needed to restore stability in financial markets and reassure a bewildered public. Its main message is that we will not overcome the crisis until we have a comprehensive and convincing set of policies in place; able to address simultaneously budgetary discipline and the sovereign debt crisis, the banking crisis, adequate liquidity provision by the ECB and dismal growth.

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## 1. The unholy compromise

From the start, it was clear that the eurozone did not meet the fundamental requirements of an optimal currency area since its factor and services markets were segmented along national lines and were plagued by massive rigidities. But it was hoped that budgetary discipline and economic convergence would tackle this problem. Furthermore, the fresh drive for financial integration, with the Lamfalussy legislative initiatives and new regulatory architecture, would make it easier to absorb asymmetric shocks hitting the eurozone by means of compensatory private financing. The lack of a supranational fiscal transfer system, as exists in all (federal) monetary unions, was not seen as a paramount problem, as cyclical stabilizers in national budgets were left free to operate.

What knocked the eurozone off course were the unintended consequences of the introduction of the common currency on the perception of credit risk, as reflected in risk premia over German lending rates when they fell close to zero and remained there until the first half of 2008 (Figure 1). Somehow, financial markets decided that all sovereign and private credit risks were now the same in all the member states and levelled the cost of financing, regardless of underlying cost and productivity trends. It was as if monetary union entailed an implicit joint guarantee that governments and banks would not be allowed to fail.

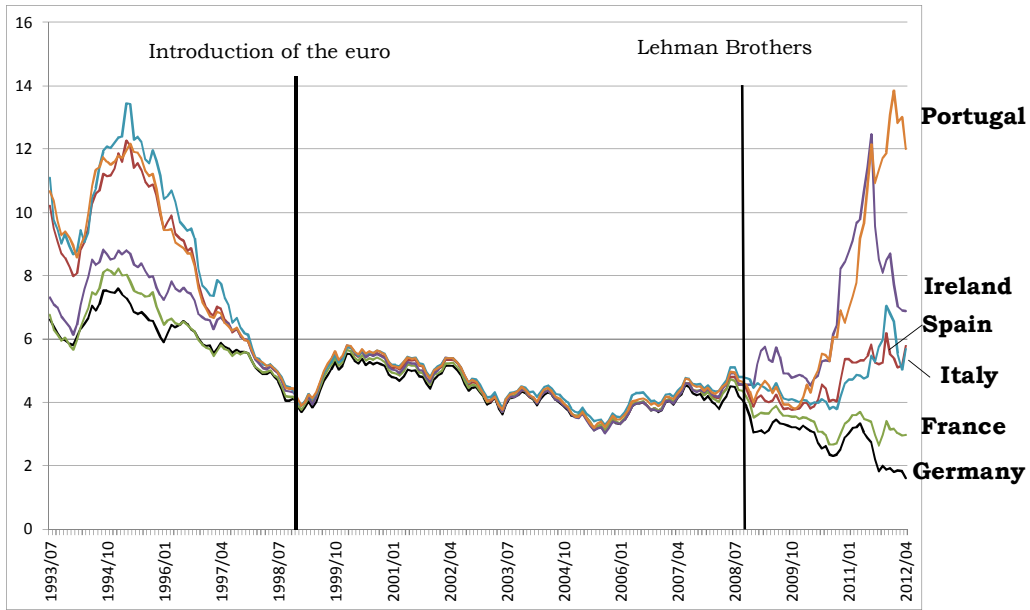
The impact on real interest rates – that is, the inflation-adjusted cost of borrowing – country by country is depicted in Figure 2. From the late 1990s on, real interest rates already increased further in Germany than in other eurozone economies and stayed there through 2007. The effect was not simply laxer monetary conditions in countries with higher (wage and price) inflation and lower productivity growth, but an explosion of lending to ‘periphery’ borrowers by ‘core’ country banks, notably German banks (Figure 3). Lax credit financed housing bubbles in Ireland and Spain and, to an extent, in France, and more broadly encouraged to postpone those structural reforms that were required for the proper functioning of the monetary union in divergent countries – including Italy, where market opening and productivity enhancing reforms stalled, after some progress in the 1990s.

Excessive debt accumulation by the private (financial and non-financial) sector and housing price bubbles were of course not unique to the eurozone and were even stronger in the US and the UK, led by unruly monetary expansion by the Federal Reserve, until the collapse of Lehman Brothers precipitated a worldwide financial crisis. What was typical of the eurozone was that the credit bubble was a direct consequence of the single monetary policy and was financed recklessly by ‘core’ country banks.

The other side of the coin – or, as in the title of this paper, of the unholy compromise underpinning the functioning of the eurozone in its early years – was massive real exchange depreciation in Germany vis-à-vis its eurozone partners (Figure 4) and the rest of the world, with enormous benefits for its exporting industry. Keeping the exchange rate low was always a main motivation for Germany to seek stable exchange rate arrangements and, later, monetary union with its European partners. Before monetary union, however, the Deutsche mark would undergo periodic revaluations that would compensate for Germany’s superior productivity performance. After monetary union, there was no such correction, leading to a massive build-up of competitive and payment imbalances within the eurozone – underpinning a very rapid increase of German exports to its Union partners (Figure 5). Seen in this light, the explosion of credit from German banks to the ‘periphery’ of the eurozone was nothing other than the financial counterpart to the accumulation of massive trade and payment imbalances within the eurozone.

If we turn to Figure 6, we see that, with the notable exception of Greece, budgetary discipline was on the whole respected up until 2007, with most countries reducing their budgetary deficits and debt stock as a ratio to GDP (including Italy). True, in 2002-03 many countries exceeded the 3% deficit-to-GDP limit due to falling economic activity, but excessive deficits were later reabsorbed as economic activity picked up.

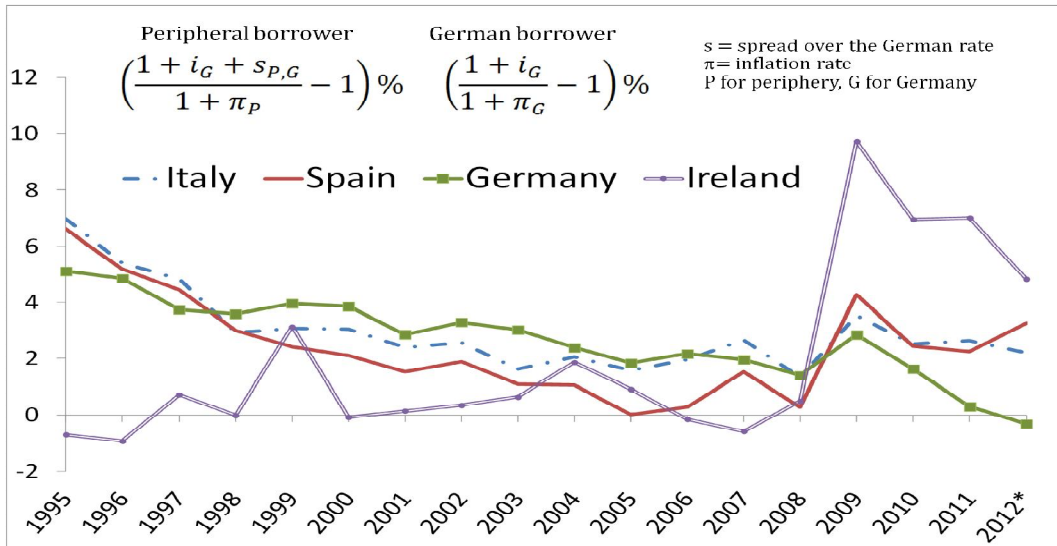
Figure 1. Eurozone bonds back to pre-euro levels  
(10-year government bonds interest rate, %)\*



\* Monthly data.

Source: ECB.

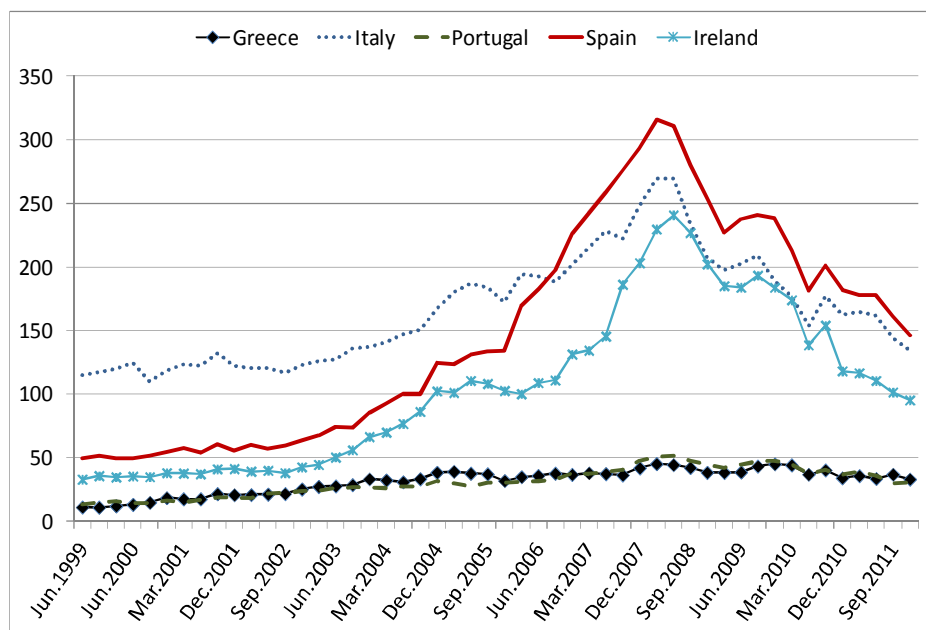
Figure 2. Real interest rates (%)



\*Data on Q1.

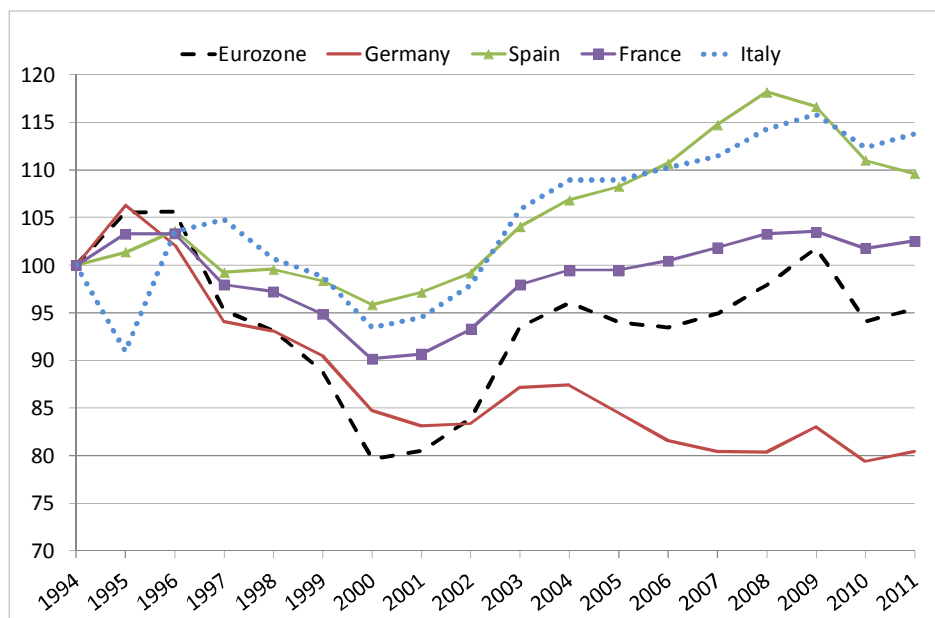
Source: OECD.

Figure 3. Foreign claims of German banks on PIIGS  
(by nationality of reporting banks, \$ bn)



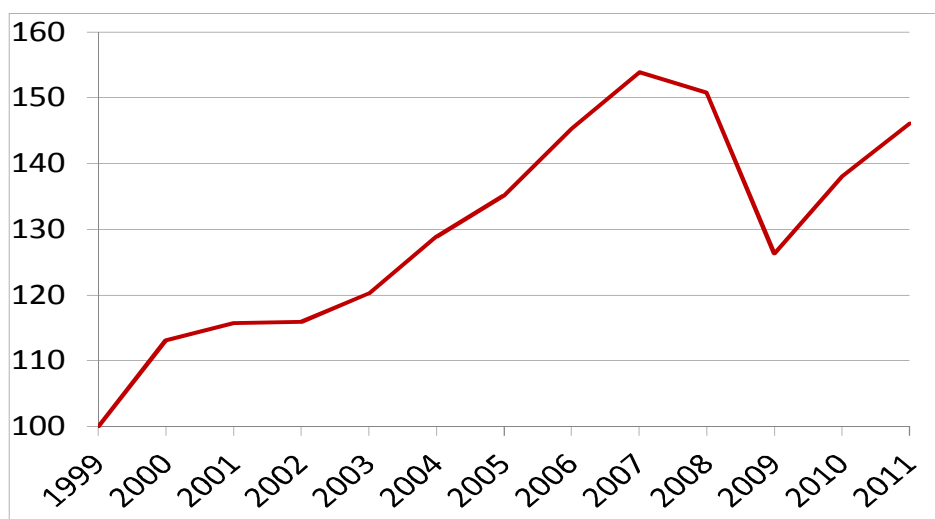
Source: BIS 2012.

Figure 4. Real effective exchange rates  
(index, 1994=100)



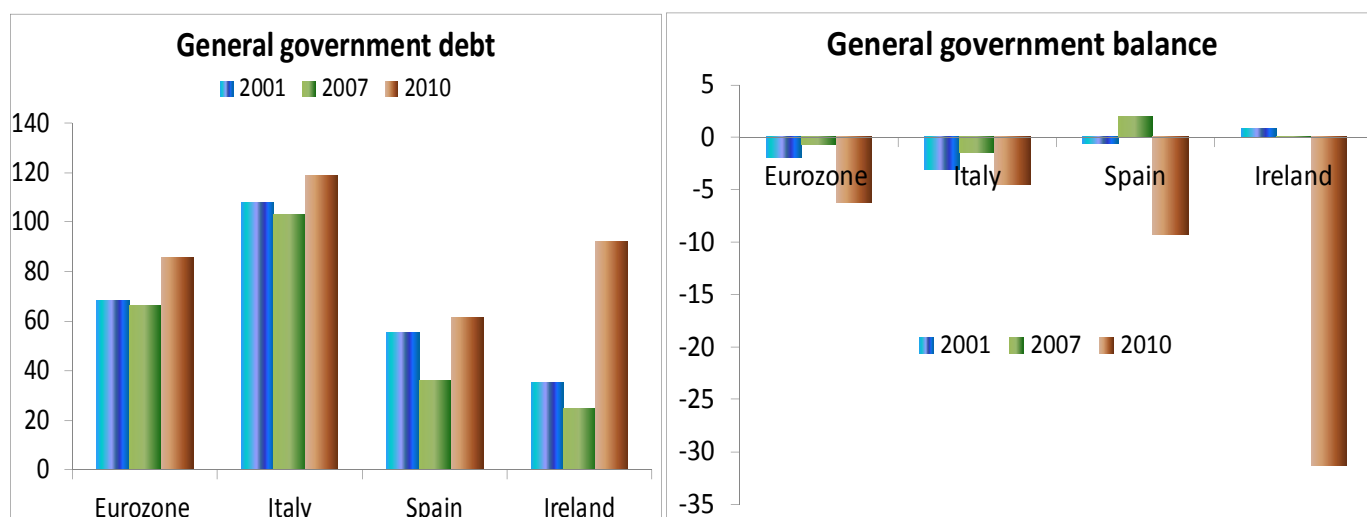
Source: Eurostat 2012.

Figure 5. German exports to the European Union (% of GDP, 1999=100)



Source: Eurostat 2012.

Figure 6. General government debt and balance, 2001, 2007 and 2010 (% of GDP)



Source: IMF WEO, April 2012.

On that occasion, however, ill-conceived policy responses by the European Commission and the Council did permanent damage to the credibility of the Stability and Growth Pact. Indeed, the attempt to enforce the 3% deficit limit on many member states simultaneously during cyclically depressed economic conditions backfired, once France and Germany refused to comply (in November 2003).

Only after the financial crisis, the need to avoid an economic and financial meltdown compelled governments to step in to support aggregate demand and make private liabilities whole, in face of rapid deleveraging by banks, households and corporations. The increase in the public sector deficit was larger in countries where the private

sector had leveraged more: Spain, but also the UK, Ireland, and the US. Italy was more prudent, and as a consequence suffered a steeper fall in output.

Thus it was, in sum, that excessive private debt was turned into unsustainable public debt and, as a consequence of economic imbalances that had been accumulated during the decade, the eurozone has become a straitjacket: where budgetary policies are tightened, growth falters and periphery countries must engineer substantial real exchange rate devaluations to regain competitiveness and reabsorb their external deficits. And 'core' countries consider there is little they can do to strengthen aggregate demand and relieve pressure on their partners.

Table 1. GDP growth, 2012 (%)

	European Commission	OECD	IMF	Latest
France	0.5	0.6	0.5	-0.1
Germany	0.7	1.2	0.6	-0.1
Greece	-4.7	-5.3	-4.7	-5.7
Ireland	0.5	0.6	0.5	0.4
Italy	-1.4	-1.7	-1.9	-2.4
Netherlands	-0.9	-0.6	-0.5	-0.7
Portugal	-3.3	-3.2	-3.3	-3.5
Spain	-1.8	-1.6	-1.8	-2.2
Eurozone	-0.3	-0.1	-0.3	-1.0
UK	0.5	0.5	0.8	-0.2

Source: European Commission, 2012 Spring Forecast; OECD Economic Outlook, June 2012; IMF WEO, April 2012; author's own estimates.

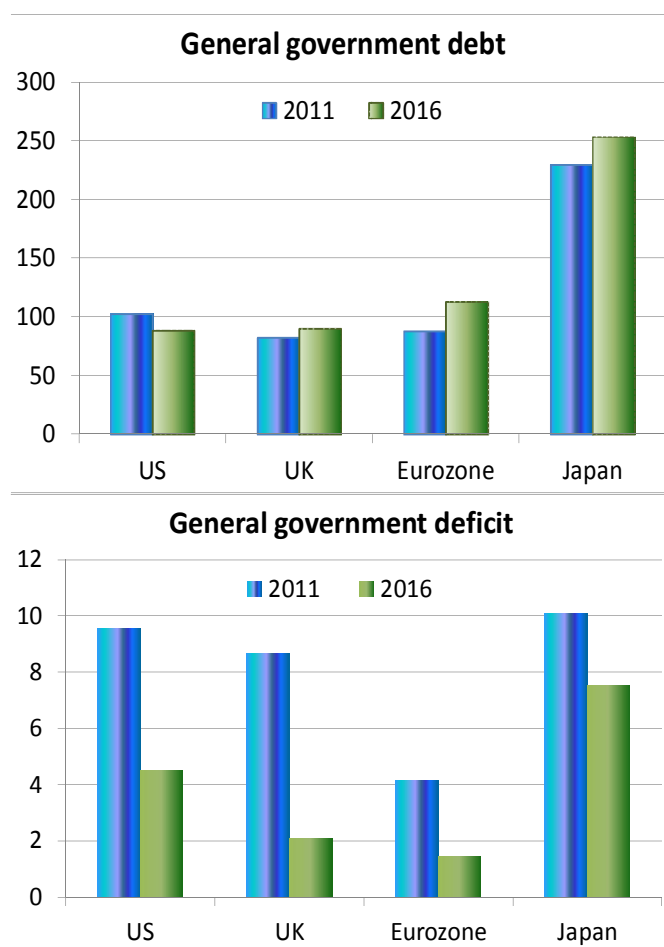
With this constellation of policies, tightening financial constraints have already resulted in a large reduction in aggregate demand in the periphery – which is also dragging the core down into recession, due to their large exposure to peripheral markets for their exports. And indeed, recent data point to a rapidly worsening economic environment also in Germany (Table 1), where the trade balance has shrunk dramatically in recent months.

## 2. Design flaws

A rapid and large increase of government debt has been a generalised phenomenon in the industrially advanced world following the 2007-09 crisis: for the first time, the average debt-to-GDP ratio for OECD countries has exceeded 100%; it is over 200% in Japan and 120% in Italy, but many other countries, including the US, have passed 100% and several yet the 90% mark. Budgetary consolidation will weigh on growth prospects for two generations to come, and the welfare state as we have known it in Europe since World War II will have to be transformed, also in response to the rapidly ageing population.

The eurozone debt crisis has features that set it apart however: while the average debt-to-GDP ratio is no higher than that in other advanced countries, and consolidation efforts started earlier resulting in a much lower deficit-to-GDP ratio (Figure 7), in the past two years the eurozone has been mired in a severe crisis of confidence.

Figure 7. General government debt and deficit, 2011 and 2016 (% of GDP)



Source: IMF WEO, April 2012.

This points to a systemic dimension of the crisis that cannot be reduced to profligate behaviour by budgetary sinners, but also has its roots in the flawed institutions of monetary union itself.<sup>1</sup> In sum, three main flaws have been made evident by developments since the Greek financial crisis started:

- i. The system lacked effective arrangements to counter divergent budgetary and more broadly economic policies; as long as enforcement of budgetary discipline is entrusted to an intergovernmental body, the problem is bound to come back, limiting the credibility of common budgetary rules.
- ii. Financial markets have underpriced private and sovereign credit risks, in the implicit belief that no one would fail and all debts would somehow be made whole, entailing weak market discipline on borrowers.

<sup>1</sup> P. De Grauwe, "The Governance of a Fragile Eurozone", CEPS Working Document No. 346, CEPS, May 2011.



iii. Once the crisis hit, leading to a re-pricing of risks in financial markets, the disconnection between monetary (centralised) and fiscal (decentralised) powers has created a vacuum de facto impeding full use of monetary instruments to absorb monetary and financial shocks, and leaving individual members of the eurozone exposed to intolerable pressure by financial markets.

Over the past two years, fundamental changes in economic governance have tried to rectify these flaws, in the main by strengthening budgetary rules and more broadly economic governance. The Fiscal Compact and the Six Pack and Two Pack legislative measures represent important achievements that should place economic policies in the eurozone and the entire Union on more solid foundations.

It should not escape our attention that a process that started out as ‘intergovernmental’ has turned ‘communitarian’ along the way. Key powers of scrutiny and proposal over the implementation of common policy guidelines, under Article 121 of the TFEU, have been entrusted to the European Commission, and the Council itself has limited its own ability to reject Commission recommendations: the latter are accepted unless a qualified majority agrees to change them. It is an important development that allows unanimity in the Council in decisions about common economic policies to be overcome as we move towards fiscal union. It will be useful to manage the further inevitable centralization of budgetary decisions.

Strong economic governance rules, however, will not suffice. History shows that a fully functioning monetary union also requires a central bank that is free to act as required to confront liquidity and confidence shocks; and some mutualisation of government debts, together with centralised control over public spending and taxation. Moreover, it must have centralised banking supervisory policies, with strong powers to manage bank crises and resolve the banks when they cannot be rescued: an essential ingredient to protect the eurozone against reckless lending and risk-taking by banks.

All this can only be achieved gradually, as we move towards a fully-fledged federal union, as Ms. Merkel is right to point out (and Mr. Hollande would be wise to heed, with full understanding of the implied surrender of sovereignty). Whether

the eurozone will survive in the meantime will be determined by the capacity of the European Council to set up intermediate arrangements capable of halting the crisis and restoring trust among its members.

In their latest meeting at the end of June, for the first time European leaders have acknowledged the multiple dimension of the crisis, accepting that austerity – putting everyone’s house in order – will not suffice. Accordingly, new joint policy initiatives will address the growth problem, banking union and the liquidity dimension. Moreover, a report on the future of the economic and monetary union, prepared by President van Rompuy in cooperation with the presidents of the European Commission, the Eurogroup and the ECB, has placed these new policies within a longer term framework and coherent vision, which may also include “the issuance of common debt” (p. 5).

### 3. The manifold dimension of eurozone stabilisation

Let us now review the main decisions taken by the European Council and the euro area summit at the end of June and the way they address the eurozone fault lines.

#### a) *The growth compact*

The European Council has agreed on a new “Compact for growth and jobs” that, while reaffirming the necessity for the member states to continue their budgetary consolidation and economic reforms, identifies a specific European dimension of growth policies that includes:

- i. Stepping up implementation of the internal market in energy, transport and communications (notably broadband)<sup>2</sup> and the

<sup>2</sup> An influential strand of thought maintains that infrastructure investment does not improve productivity, mainly based on the US experience of strong growth with poor road and rail networks and dismal public utility services. The European variant has it that Europe already has all the infrastructure that it needs and that further investment would be wasted. This view seems unconvincing. For instance, recent research on a large sample of countries reported in VoxEU (“Fiscal spending and growth: More patterns” by C. Carrière and J. de Melo, 17 May 2012) finds that a shift in discretionary expenditures towards transport and communications “was only observed for fiscal events followed by growth events”. In many EU countries, including Italy and

services Directive. The member states will be held accountable for their actions and inactions on this score under the new European Semester procedure, based on a Commission report.

- ii. With a view to boosting financing of the economy, all available funds at Community level will be mobilised in support of infrastructure investment for the internal market. Although the numbers are not large relative to the eurozone economy (about 1%), they are not inconsequential; furthermore, by removing physical obstacles to the functioning of the internal market, these investments may bear larger fruits in terms of efficiency and cost reduction.

What is notably missing is the recognition of the need for greater flexibility in budgetary consolidation efforts. There are two aspects to this issue. First, as the Commission had requested in its Communication “Action for Stability, Growth and Jobs”,<sup>3</sup> countries with stronger budgetary positions should consider slowing their consolidation efforts in order not to aggravate the recession. Secondly, in order to preserve the confidence of investors, a number of eurozone countries must strike a difficult balance between budgetary austerity and the need to avoid an economic overkill that would frustrate budgetary consolidation.<sup>4</sup> This difficult balancing act would have been facilitated by a clear statement by the European Council confirming that letting automatic stabilisers work, while remaining on track with ‘structural’ budgetary targets, fully complies with EU obligations.<sup>5</sup> The good news is

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Germany, over the past decade public investment has been low, sometimes below what was needed solely for depreciation and maintenance. Moreover, the creation of a functioning market for gas and electricity and for digital services requires large, and surely profitable, investment to establish the connections between segmented national markets – investment that was held back by national monopolists and that is a source not only of higher prices and lost productivity gains, but in the case of gas also of a dangerous concentration of supply with a politically unreliable partner such as Russia.

<sup>3</sup> COM(2012) 299 of 30.5.2012, final.

<sup>4</sup> C. Cottarelli, “The austerity debate: Festina lente!”, VoxEU, 20 April 2012.

<sup>5</sup> The prime minister of Italy, Mario Monti, has also proposed to exclude certain public investments of ‘European added value’ from the balanced budget rule. The proposal should not be too difficult to accept to the

that the Council is not unaware of the problem, as clearly shown by the Eurogroup decision, on July 9, to give Spain one more year to achieve budgetary balance.

Moreover, a greater share of the adjustment burden must fall on Germany. The relatively generous wage agreements recent reached in Germany will help, but they are not enough: there is also a need to step up domestic demand. More aggressive liberalisation of the bloated banking system, network services, especially in energy and transport, and public procurement may provide over time a significant contribution to raising domestic investment and income. The sizeable investments required to make up for the loss of nuclear energy may contribute more immediate stimulus. All this should not be seen as a concession, but must be recognised as part of the obligations undertaken by eurozone governments with the new procedure for excessive imbalances, although so far the Commission has somewhat shirked its responsibility to apply it even-handedly.<sup>6</sup> Germany should be convinced that without its own contribution in reviving growth and correcting external payment imbalances, the eurozone will not escape prolonged depression and will be doomed.

### *b) Bank rescues*

As cross-border interbank flows between creditor and debtor countries have shrunk to a trickle, there has been a growing concentration of sovereign debt with national banks in crisis countries – facilitated by carry trade operations undertaken by banks with ECB LTRO funds to repair their damaged balance sheets. As a consequence, most private holdings of Greek public debt are now concentrated with Greek banks, and more than half of public debt in Spain is held by Spanish banks.

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extent that the return on those investments is sufficient to cover interest costs and the repayment of principal. If, on the other hand, an element of subsidy is required, this should be included in current spending and the budgetary balance. The Commission could be asked to ascertain whether these conditions are met and clear the exceptions to the balanced budget rule.

<sup>6</sup> Report from the Commission, “Alert Mechanism Report. Report prepared in accordance with Articles 3 and 4 of the Regulation on the prevention and correction of macro-economic imbalances”, COM(2012) 68 final of 14.2.2012.



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

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

The European Council has now rectified this mistake and has decided that the EFSF/ESM funds will be used to inject funds directly into Bankia and other ailing Spanish banks, subject to a Memorandum of Understanding (MoU) with appropriate conditionality – but has made this possibility subject to the establishment of "an effective single supervisory mechanism ... involving the ECB". It has also decided that these loans will not enjoy seniority status so as not to avoid undesirable repercussions for other outstanding debt. The final approval of the support measures by the Eurogroup is expected by July 20<sup>th</sup> and disbursement of the funds should endue shortly thereafter; the Spanish government will be liable for the capital injection until the new mechanism for centralised bank supervision is in place.

On this, two observations are in order. Firstly, in designing its centralised supervision system for cross-border banks, the Union should adopt an FDIC-type prompt corrective action system, in which supervisors will be bound by an obligation to act when bank capital falls below certain thresholds, in full public light. This is essential in order to overcome supervisory forbearance, i.e.

the tendency for supervisors to conspire with their regulated entities in delaying loss recognition and corrective action.

Secondly, when banks lose money, their shareholders and creditors should cover them before any deployment of taxpayers' money. The timing of loss recognition is essential in order to reconcile creditors' participation in the losses with the need to avoid further destabilization of financial markets in the present juncture. To this end, when the EFSF/ESM step in with their funds, they should initially receive (non-voting) preferred shares of the bank, entailing minimal cost (the EFSF borrowing cost plus a fee), redeemable within a reasonable time span, say three years. During this period, shareholders should be given a chance to restore the bank to health, if need be with new management, and pay back the EFSF/ESM what they were given. However, should they fail to redeem them, those shares should become full voting shares and the EFSF/ESM should take over the bank to restructure it and, if need be, resolve it. At that time, not only shareholders, but also subordinated, and even senior unsecured creditors of the banks should be called to contribute, perhaps as has been suggested with forced conversion of debt into equity.<sup>7</sup>

### *c) Stabilizing interest rates spread*

As mentioned, a major source of financial tensions in the eurozone has been the constraints on the possibility of using its currency for financial market stabilization. These constraints mainly reflect the absence of a centralised fiscal power – a eurozone Treasury – able to provide ultimate backing to the ECB for its banking and sovereign debt stabilization operations. Of course, when push comes to shove, the ECB has little choice but to intervene as required to stop contagion and the melt-down of sovereign and banking markets.

In this context, a most controversial decision taken by the euro area summit concerns the commitment "to ensure the financial stability of the Eurozone, in particular by using the existing EFSF/ESM instruments in a flexible and efficient manner in order to stabilize markets for Member States respecting their country specific recommendations and their other commitments

<sup>7</sup> See J.R. Rallo, "A Better Way to Save Spain's Banks", *Wall Street Journal*, 15-17 June 2012.

...". The interventions will be undertaken by the ECB, acting as an agent of the EFSF/ESM.

On this, please note that the Council had already decided to let the ESM undertake sovereign debt purchases or swaps in the secondary markets, as required by the effective implementation of its assistance programmes. The little extra step now has been to contemplate explicitly market interventions to stabilize interest rate spreads in countries that are forcefully addressing their domestic imbalances. The ensuing public debate seems to have overlooked the fact that these market interventions would in no way represent additional finance for the beneficiary countries, since they would take place in the secondary markets. They would not be dissimilar from quantitative easing interventions undertaken by the US Federal Reserve and the Bank of England to lower long-term interest rates in depressed economic conditions.

What may seem awkward is the decision to entrust these interventions to a government fund, rather than the ECB itself. It would have been more straightforward to encourage the ECB to resume its securities purchase programme – which it had abandoned at least in part due to relentless opposition by some members in its Governing Council – while earmarking EFSF/ESM funds to effectively insure the ECB against any losses stemming from such market operations. Entrusting the EFSF/ESM has the additional drawback that the funds available for intervention are limited, which inevitably weakens the deterrent effects on sovereign eurozone paper short-sellers.

We turn now to discussing why this action to lower interest rate spreads within the eurozone is necessary.

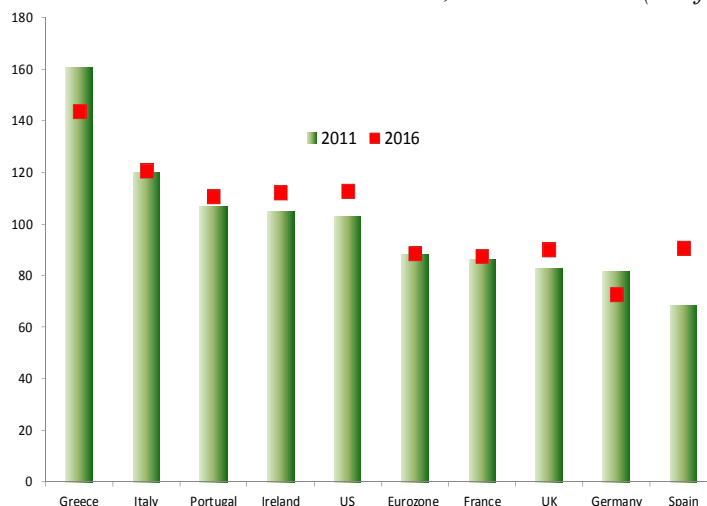
#### 4. Managing the debt overhang

As already mentioned, few would disagree that fiscal union will eventually entail some mutualization of sovereign debts. However, action on this front may be needed soon, for two reasons. There is an issue of economic sustainability of adjustment: the increase in interest rates risks frustrating ongoing efforts at budgetary consolidation and indeed pushing indebted countries beyond the point of dynamic instability. It should not be overlooked, in this regard, that – should Spain or Italy lose market access – the attendant costs for Germany would climb steeply both if it decided to rescue them or if the euro was let go and the eurozone broke up.

And there is an issue of political sustainability: political support for painful and protracted adjustment programmes cannot survive without stronger signs that sacrifices will bear fruit – which cannot happen unless the sovereign risks are somewhat shared.

A cursory look at Figure 8 confirms that the issue of debt sustainability is a serious one. According to IMF estimates, under current growth and interest rate scenarios, by 2016 the debt-to-GDP ratios of most eurozone countries will basically not diminish or only do so marginally, and as a result the average debt-to-GDP ratio for the eurozone will actually increase.

Figure 8. Public debt in selected countries, 2011 and 2016 (% of GDP)



Source: IMF WEO, April 2012.

The main exception is Germany, where the ratio will decline below 80% – but nonetheless remain well above 60% (some decline is also observed for Greece, but this is of course the result of debt restructuring). This is the most difficult issue since German taxpayers must be convinced that they are not asked to make good the debts incurred by others. The good news is that a proposal that meets this requirement exists, namely the proposal for debt redemption put forth by the German Council of Economic Experts.<sup>1</sup>

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

Table 2 throws some further light on the issue. The left-hand columns report current and structural primary balances – i.e. total expenditures minus revenues and interest payments – in 2011 of selected eurozone members, and in the centre column the primary balances implicit in budgetary targets agreed by each country under the excessive deficit or broad policy guidelines procedure (3<sup>rd</sup> column from the left). The table also reports the longer-term estimates prepared by the OECD of primary balances required to bring the debt-to-GDP ratio to 50% by 2050 (4<sup>th</sup> column). The latter estimate is interesting since it incorporates long-term pressures deriving

from pensions, health and long-term care. As may be seen, on this score, Italy looks better than France, Germany and the Netherlands, mainly thanks to its pension reform.

The table highlights that indeed strenuous efforts will be required over decades to maintain acceptable budgetary balances: clearly, what is asked from Greece and Spain (and Ireland?) may not be realistically achievable, pointing to the need of relaxing existing commitments (as the Ecofin has indeed decided to do for Spain at its July 9<sup>th</sup> meeting). The European Redemption Pact (ERP) would make these efforts manageable by reducing the interest rate costs: the savings are substantial and may indeed make the whole difference between (economic and political) sustainability and un-sustainability.

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

<sup>1</sup> German Council of Economic Experts, “Euro Area in crisis”, Annual Report 2011/12, Third Chapter, Wiesbaden, November 2011. See also P. Bofinger, L.P. Feld, W. Franz, C.M. Schmidt and B. Weder di Mauro, “A European Redemption Pact”, VoxEU, 9 November 2011; and H. Doluca, A. Hübner, D. Rumpf, B. Weigert, “The European Redemption Pact: An Illustrative Guide”, German Council of Economic Experts, Working Paper 02/2012, February 2012.

Table 2. Budgetary consolidation requirements (% of GDP)

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

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

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

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

## 5. Conclusions

Over the past two years, we have managed collectively to transform the debt crisis of a small, almost marginal member of the eurozone into an existential crisis of our common currency. This has happened because the Greek crisis has brought to full light serious fault lines in the economic governance of the eurozone. Subsequently, we have made substantial progress in mending these faults, but disagreements and policy inconsistencies along the way have offered ample opportunities to speculators to attack our sovereign debt markets, massively raising the adjustment costs.

Financial market pressures will not subside until we can reach a solid consensus on a policy framework capable of reconciling austerity with growth, dealing with the debt overhang, and ensuring that the ECB can provide adequate liquidity support without endangering its balance sheet and independence. The good news is that the European Council and euro area summit have finally come to recognize all these ingredients as essential to stabilize financial markets and restore the eurozone economy to good health. If only our leaders could stop quarrelling in public like cantankerous old men (and one lady) even when they basically agree on what needs to be done, the situation would improve much more rapidly.



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