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Thinking ahead for Europe

A European Monetary Fund
Why and how?

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Abstract

We argued as early as 2010, at the outset of the sovereign debt crisis, that Europe needs a European Monetary Fund (EMF). In the meantime, the European Stability Mechanism (ESM) has been created, which performs the function of an EMF. It was critical in containing the cost of the crisis and four of its five country programmes have been a success. But the case of Greece shows that one needs to be prepared for failure as well. We propose in this paper to keep the ESM essentially as it is, but would empower it to set conditions on countries receiving its financial support. Such support would have a limit, however, to prevent situations in which the ESM would 'own' a country.

We see the ESM/EMF literally as a financial stability mechanism, whose main function is to ensure that a bailout is no longer *"alternativlos",* as Chancellor Angela Merkel used to say. In 2010, the rescue of Greece was presented as TINA (There Is No Alternative) because the stability of the financial system of the entire euro area appeared to be in danger. With financial stability guaranteed by the ESM/EMF in combination with the Banking Union, default becomes an alternative that should be considered dispassionately. Whether the debt of a country is sustainable is rarely known with certainty beforehand. Accordingly, it is proper that the Union, in the 'spirit of solidarity', initially gives a country the benefit of the doubt and provides financial support for an adjustment programme. But the exposure of the Union should be limited. If the programme goes awry, the ESM/EMF could be of great help, as it could provide bridge financing to soften the cost of default.

Keywords: European Monetary Fund; European Stability Mechanism; EMU reform; debt restructuring in EMU; EMU exit

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A European Monetary Fund: Why and how?

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Introduction

Calling for a 'European Monetary Fund' (EMF) has become fashionable. European Commission President Jean-Claude Juncker became a convert in his latest State of the Union speech of September 13th, and the Commission endorsed this concept in its 'St Nicolas' package of proposals to improve the governance of the euro area. Several German policy-makers have also called for a transformation of the European Stability Mechanism (ESM) into an EMF.

However, the various advocates of a European Monetary Fund have very different ideas about its purpose and functions. We look at the essential functions of an EMF and ask what changes would be needed to the ESM in order to improve the functioning of the euro area.

Since we were among the first to propose the creation of an EMF, we start with a short background of this idea. We then turn to how the ESM has performed so far and sketch the (limited) changes we regard as essential.

1. The history

When we first published our proposal for an EMF in February 2010, Greece was still struggling on its own to avoid default. Following the revelation of a much higher government budget deficit in 2009 than earlier expected, 10-year government bond yields had increased from 4.5% in August 2009 to 6.1% in January 2010. Although the prospects for Greece being able to roll forward maturing debt in the market were slim, our proposal met widespread rejection. Most people felt that EU institutions were unable to agree on financial support for a country at risk of default in view of the no-bailout clause enshrined in the Maastricht Treaty. Treaty change was seen as impossible, and our proposal was seen at best as a project for the distant future.

Two months later, however, things had moved on very fast. On Sunday, 2 May 2010, Greece received its first support programme, with the funds coming from bilateral loans from other economic and monetary union (EMU) countries. But the moved failed to calm markets, and market participants lost confidence in the liquidity and solvency of other EMU countries. This prompted the European Council (in this case the meeting of the heads of state and government of the euro-area states) on the following Sunday, 9 May, to create a €500 billion fund dubbed the European Financial Stability Facility (EFSF) to be able to give support to a broader group of countries.

Because the EFSF needed time to be organised, on the same day the European Central Bank (ECB) launched a government bond purchase programme, dubbed the Securities Markets

Programme, with a view to bolstering the sagging prices of bonds issued by euro-area governments. The EFSF was originally foreseen to be temporary, but the evolution of the crisis, with Portugal and Ireland needing funding (and the Greek programme not succeeding) showed that there was a need for a permanent structure to help countries in temporary financial difficulties. The EFSF was then de facto merged into the permanent ESM in late 2012. In the summer of that year, the crisis seemed to spread to two large countries, Italy and Spain. At this point, it appeared that the entire euro area was in danger of dissolving. This prompted the president of the ECB to assert that his institution would do 'whatever it takes' to prevent a disintegration of the euro. Financial market tension then abated rapidly and the ECB replaced the Securities Markets Programme with the Outright Monetary Transaction (OMT) Programme (in September 2012).

The OMT has since been widely credited as providing an indispensable safety net. But in reality, the activation of the OMT (under which the ECB would buy only short-term government bonds) is subject to the conclusion of an ESM programme. The purpose of the OMT was not to substitute the ECB for the ESM, but to ensure the credibility of the euro area as a whole when the stability of the entire area is in danger. In such a situation, the resources of the ESM would clearly be insufficient. The International Monetary Fund (IMF) is likewise responsible for providing adjustment financing for individual countries, but its resources would not be sufficient to deal with a European financial crisis. In short, while in early 2010 a European Monetary Fund seemed to be utopic, it has come de facto into existence since late 2012.

2. The original idea

Our initial blueprint (Gros and Mayer, 2010) was, of course, very much affected by what was then the key problem, namely the case of Greece. We addressed five main issues:

1) **Financing mechanism.** We envisaged capital contributions to the EMF based on the potential risk a country represents to the EMU. Hence, we proposed that countries breaching the Maastricht criteria would make higher contributions based on the excess of their public debt and deficit ratios above 60% and 3% of GDP, respectively. We expected that our mechanism would create a capital base of €120 billion over time, which could be leveraged to a funding capacity of at least €500 billion through borrowing.

2) **Conditionality.** We thought that there should be two stages. In stage I any EMF member could call on the capital (and cumulated interest) it had subscribed – possibly in the form of an EMF guarantee of new issues of public debt, provided its fiscal adjustment programme was approved by the Eurogroup. In stage II, use of assistance from the EMF greater than the capital subscription would be dependent upon a tailor-made adjustment programme supervised by the European Commission and the Eurogroup.

3) **Enforcement.** If a country did not live up to its commitments, new financial assistance would be cut off. A continuing breach of conditions would lead to cut-offs from structural funds and, in the event, from the euro area's money market as the public debt of the offending country would no longer be eligible as collateral for ECB funds under a repurchase agreement.

4) **Orderly default.** We felt that one needed to recognise that default is possible. For this to be the case, the costs of default would have to be contained. If a country cannot make the necessary adjustment effort, it would be in everybody's interest to cut the debt burden. To make restructuring possible, we suggested the Brady bond model, whereby bad debt is exchanged against safe debt backed by the EMF with a haircut.[1] We thought that the size of the haircut should be such that it would bring down the debt ratio of the country in question to the Maastricht limit of 60%. In return for exchanging bad debt against safe debt, we suggested that the EMF acquire all claims against the defaulting country. From that time onwards, any additional funds the country received could be used only for specific purposes approved by the EMF. Other EU transfer payments would also be disbursed by the EMF under strict scrutiny, or they could be used to pay down the debt owed by the defaulting country to the EMF. Thus, the EMF would provide a framework for sovereign bankruptcy comparable to the Chapter 11 procedure in the US for bankrupt companies that qualify for restructuring. Without such a procedure for orderly bankruptcy, the Community could be taken hostage by a country unwilling to adjust, threatening to trigger a systemic crisis if financial assistance is not forthcoming.

5) **Exit.** Since member states of the EU remain sovereign countries, we acknowledged that a defaulting country could regard such intrusion into its policies by the EMF as a violation of its sovereignty and hence unacceptable. But an E(M)U member country that refused to accept the decisions of the EMF would of course lose access to financing from the EMF and would then have the choice between introducing capital controls or leaving the euro. At the same time, its debt towards the EMF would continue to exist and would have to be serviced anyway. If a country did not do this and refused all cooperation, its membership of the EU would be called into question.[2]

We will discuss the extent to which these concerns have been addressed after a brief analysis of the experience so far.

[1] The Brady plan offered two options: i) exiting for those investors willing to take a haircut, and ii) remaining invested, but in this case also providing fresh money. In the Brady plan, the reduced principal amount was *partially* collateralised by specially issued US Treasury 30-year zero-coupon bonds purchased by the debtor country using a combination of IMF, World Bank and the country's own foreign currency reserves. Accordingly, we expected the debt of the defaulting country after the haircut to be collateralised by EMF guarantees.

[2] In extreme cases it could effectively be thrown out by recourse to Art. 60 of the Vienna Convention on International Treaties, or Art. 7 of the Treaty of Lisbon could be invoked.

3. The experience so far

The track record of the five adjustment programmes the ESM (and its predecessors) have undertaken is mixed.

Four of the five rescue programmes have already ended, and could be described as a qualified success. The financing difficulties of Portugal, Ireland and Cyprus turned out, *ex post*, to be temporary (although these countries continue to depend on low interest rates due to their high levels of debt), and the recapitalisation of the Spanish banking system was not so expensive. These adjustment programmes have of course been widely criticised as being too harsh – a criticism levelled against most IMF programmes. There is no need to take a stance on this issue here. What matters is that the financing of the ESM avoided three further defaults (and in the case of the small programme for Spain alleviated that fear considerably). The ESM hence performed the standard function of a 'European Monetary Fund'.

The political cost of even these 'successful' cases has been high. The financial assistance packages are not remembered for what they prevented (insolvency and financial collapse), but for the perceived cost of the 'austerity' in terms of incomes, employment and output. As William Shakespeare remarked centuries ago, lending is an ungrateful business, as the lender risks losing both the friendship and his money. [3]

The one case that is almost universally regarded as a failure is that of Greece. The country obtained considerable debt relief but still needed three programmes of ever-increasing amounts, and there is little sign even today of a sustained recovery. In the following analysis we will concentrate on the Greek case and ask what features of the ESM framework might be changed to prevent similar problems in future. Before this, we check to what extent actual developments have been in line with our earlier recommendations.

4. Similarities and differences

When we compare our early blueprint with what has been created so far, we find a considerable number of differences, as presented below.

1) **Financing mechanism.** While we envisaged financial contributions based on the potential risk a country represents to the EMU (e.g. its debt level), contributions to the ESM are based on countries' shares of the capital of the ECB (the simple average of the respective country's shares in the total population and GDP of the euro area). Applying the ECB's capital keys to the ESM has had the effect that smaller countries, potentially more exposed to the risk of sudden stops in cross-border financial flows, also have smaller capital shares in the ESM. This is obviously inconsistent with the key principle of insurance, where contributions to a common pool are not only based on the size of the risks covered, but also the exposure of the insured to these risks.

[3] - "For loan oft loses both itself and friend" (Hamlet, edited by A. Thompson and N. Taylor, Arden Shakespeare, 3rd series, London: Thomson Learning, 2006).

2) **Conditionality.** Comparable to our two-stage model for access to funds and the associated conditionality, the ESM offers several stages of access, ranging from precautionary credit lines and the purchase of bonds of a member state in primary and secondary markets to adjustment loans. In addition, the ESM can also lend to member states for the purpose of recapitalising insolvent banks and under certain conditions recapitalise these entities directly. All financial assistance by the ESM comes with policy conditions specified in a memorandum of understanding agreed with the European Commission, the ECB and (where applicable) the IMF. So far, so good. However, the involvement of the ECB in the design and monitoring of financial assistance is problematic, as it blurs the distinction between monetary and fiscal policy. Moreover, the continuing involvement of the IMF in intra-EMU affairs cannot be taken for granted, given the institution's global mandate and shareholder base. Finally yet importantly, the European Commission's new understanding of its role as a "political commission" (as it was described by Jean-Claude Juncker) is incompatible with the job of designing and monitoring conditional financial assistance (where political aspects ought to be minimised).

3) **Enforcement.** Contrary to our idea of a strict enforcement of the conditions for financial assistance, the bodies entrusted with the monitoring of assistance (the so-called Troika, consisting of the ECB, IMF and the Commission) have shown considerable leniency (although this is generally perceived very differently in the programme countries). Repeated non-compliance has been met with base drift or a watering down of the benchmarks. Not all of it has been the result of policy slippage in the programme countries. Some of the benchmarks were impossible to reach because, at least at the start, the underlying economic assumptions (notably on exports and growth) were much too optimistic. In the case of Greece, for example, the result was that after much delay the country reached most fiscal targets and passed most reforms. But it also became apparent that while the Greek government and parliament could be pressured to pass all the laws and regulations demanded by the creditors, it proved impossible to reform the administration, whose inefficiency and obstruction had in many cases the result that few structural reforms were actually implemented.

4) **Orderly default.** As already mentioned, Greece benefited in March 2012 from a €107 billion debt reduction, equivalent to a 53.5% haircut on the principal value of about 97% of outstanding bonds held by private sector creditors (€197 billion).[4] Yet, the process leading up to this result was anything but orderly. The announcement in late 2011 by the French and the German leaders that some form of haircut would be considered greatly unsettled financial markets.

5) **Private sector involvement.** The EFSF supported the restructuring in a way similar to the earlier Brady plan. In the so-called private sector involvement (PSI) facility, Greece

[4] Bonds held by official creditors, notably bonds acquired by the ECB under its Securities Markets Programme, were exempted from restructuring.

offered investors one- and two-year EFSF bonds. These EFSF bonds, provided to holders of bonds under Greek law, were subsequently rolled over into longer maturities. In the bond interest facility, Greece offered investors EFSF six-month bills in order to enable it to repay accrued interest on outstanding Greek sovereign bonds under Greek law that were included in the PSI. The bills were also subsequently rolled over into longer maturities. The operation largely followed the pattern we had envisaged. Still, although the debt reduction of €107 billion amounted to 56% of nominal GDP at the end of the second quarter of 2012, the actual debt-to-GDP ratio at the end of the year was only 12 percentage points lower than before the debt reduction (160% of GDP at the end of 2012 versus 172% at the end of 2011). This stemmed from a number of reasons. First of all, the headline debt reduction of €107 billion is misleading, since the approximately €60 billion of debt held by Greek banks was nominally cut into half, but the EFSF then had to immediately lend the Greek government €30 billion to recapitalise the banks. Moreover, even in 2012 the Greek government was still running a sizeable deficit, which needed to be financed from external sources. On top of this, the 'sweeteners' provided to some investors in the PSI operation also increased the debt of Greece towards the EFSF. Finally, nominal GDP continued to decline, thus increasing the debt-to-GDP ratio. To achieve a more substantial debt reduction without imposing an even greater haircut on private creditors, official creditors would have had to participate in the exercise. Their refusal to do so was one of the reasons that the exercise failed and the sacrifice of the private creditors was in vain.

6) **Make failure possible?** At the conclusion of their crisis meeting on 21 July 2011, the European Council members stated:

> As far as our general approach to private sector involvement in the euro area is concerned, we would like to make it clear that Greece requires an exceptional and unique solution. All other euro countries solemnly reaffirm their inflexible determination to honour fully their own individual sovereign signature and all their commitments to sustainable fiscal conditions and structural reforms.

This statement may have been necessary to calm markets after the announcement of Greece's partial default, but it also seemed to close the window for any further, orderly, public debt restructuring in the euro area. Fortunately, European Council Conclusions have no direct legal power. Moreover, the statement is sufficiently ambiguous. It does not say that defaults should never occur again, only that "Greece requires an exceptional and unique solution". Future defaults will certainly be different and require a different "unique solution".

7) **Exit.** As we expected, populations in crisis countries regarded the intrusion into their policies by the euro-area crisis management as a violation of their sovereignty and hence resisted this strongly. Greece twice came close to exiting the EMU. In 2012 and 2015, the idea of creating a Greek parallel currency to the euro was considered by the Greek government. And during the negotiations of a third assistance programme in 2015, the

German finance minister proposed to the Council of Ministers a temporary exit of Greece from the EMU. According to press reports, apart from Greece itself, the German proposal was opposed by France, Italy, Spain and Luxembourg. It was finally dropped at the following meeting of the European Council. But the idea of exiting the euro (or that of introducing a parallel currency) has not died. It is still actively discussed by major political figures in Italy, for example.

In sum, both the crisis management and design of crisis-management institutions have been overshadowed by deep – one could even say “philosophical” – differences of opinion about the role of discretionary policy and contractually agreed rules (Brunnermeier et al., 2016). This often resulted in poor compromises, which rendered a resolute solution of the crises more difficult, and left many market participants confused and sceptical about the survival of the euro. It eventually took the de facto guarantee of the ECB to use its unlimited monetary firepower to defend the euro to calm markets. There is nonetheless a general consensus that the intervention of the ECB can only be of a temporary nature. To put EMU on a firm footing, more comprehensive institutional changes are required.

Experience has shown that a public debt crisis can arise from two sources: i) overspending by the government itself, and ii) a financial boom–bust cycle that leads to a deep recession and forces the government to bail out its banks. Greece and Ireland represent the two archetypal cases. In principle, there are now mechanisms that should make both less likely. The provisions of the Bank Recovery and Resolution Directive (BRRD), which require a high level of capital (approximately 8% of the balance sheet) that can be ‘bailed in’ before public sector support is needed, should already drastically reduce the burden of future financial crises for public finances.[5] Moreover, the common funding for bank restructuring available from the ‘Single Resolution Fund’ would further reduce, perhaps even eliminate in most cases, the need for national governments to provide financial support for their banks.[6]

The Fiscal Compact mandates a continuous reduction in debt-to-GDP ratios, which should significantly diminish the probability of future public-finance excesses. Theoretically, the need for EMF assistance should likewise diminish over time. In practice, however, implementation of the Fiscal Compact has remained patchy. We therefore concentrate on the analysis of the first type of crisis, hoping that it will at least have become less likely, thanks to whatever limited effect the existing fiscal rules have.

[5] - Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms, OJ L 173, 12.6.2014.

[6] De Groen & Gros (2015) show that the Single Resolution Fund would have been enough to cover the need for bank restructuring funding during the euro crisis had the BRRD rules been strictly applied.

5. What we would now do differently

As the idea of a European Monetary Fund has made it back onto the agenda for the completion of EMU, we thought it worth asking what we would change to our earlier proposal with the benefit of hindsight. Here are the main points:

1) **Limiting financing.** To avoid turning a crisis-assistance facility into a scheme for permanent transfers, and subsequent dependency, as has de facto happened for Greece, financial assistance should be limited. The IMF has recently adopted access limits for its own lending, which imply that under ordinary circumstances financial assistance is limited to five times the quota the country has in the IMF. A similar limit seems appropriate for the ESM/EMF. That being stated, IMF quotas are determined somewhat differently from those of the ESM. Quotas in the ESM are the same as those in the ECB, which are an equally weighted mix of GDP and population. This corresponds closely to the most important element in the quota formula of the IMF, which assigns a weight of 50% to GDP, 30% to openness and 15% to economic variability. The latter two factors are very much related to country size: smaller countries are typically more open and are often more exposed to shocks for the simple reason that small economies are less diversified. To capture differences in risk exposure one might modify the overall access rule of five times the ESM quota by increasing the 'multiplier' for small countries to seven (times the ESM quota) and reducing it also to three times for the very large countries.

   Table A1 in Appendix 1 shows the resulting access limits, together with actual ESM funding in the five programmes that were undertaken. Had this key been applied to the programme countries, the assistance to Greece would have been many times larger than the actual ESM provided to the country. For Spain and Cyprus, our proposed limits would not have been a constraint. The assistance to Ireland and Portugal would have been above the limit if one combines IMF and ESM funding. If one deducts the financial assistance used for bank recapitalisation, the Ireland and Portugal programmes would have been considerably smaller and our proposed access limits would not have been binding. In the case of Ireland, €24 billion of the total assistance of €67.5 billion was used for bank recapitalisation, leaving €43.5 billion for fiscal support (equivalent to 110% of our proposed access limit). Notably, part of the fiscal support had become necessary because the Irish government had already injected €46 billion into the banking sector beforehand. Had the government not stepped in to bail out bank creditors, it is doubtful whether Ireland would have needed financial assistance at all. In the case of Portugal, €12 billion of the total assistance of €78 billion was used for bank recapitalisation, leaving €66 billion for fiscal support (106% of our proposed access limit). Thus, without the additional bank recapitalisation, our proposed access limit would have allowed for providing assistance of roughly the size granted for fiscal support. As mentioned above, in future, national funding for bank recapitalisation should no longer be needed given the bail-in rules of the BRRD and the Single Resolution Fund. The need for financial assistance to governments should be considerably reduced once the Single Resolution Fund becomes fully operational, which will be the case soon.

2) **Conditionality.** With hindsight, the various stages of access to ESM assistance would also seem appropriate for the EMF. However, design and monitoring of adjustment would have to be given to a European institution at arms' length of politics. Therefore, the EMF would have to develop its own capacity to monitor economic developments and implement adjustment programmes (although the European Commission will continue to play a role in economic monitoring as enshrined in the EU Treaties). With access to financial assistance limited, the length of programmes should also be limited to, say, three years (in line with standard IMF practice). To avoid the substitution of private debt by public debt during the programme, debt service payments would need to be suspended for the duration of the adjustment programme (see also appendix 1). The governance structure of the ESM would seem to be appropriate to task ESM staff with programme design and monitoring, and the board of directors with approval of staff decisions. The roles of the ECB, IMF and Eurogroup would become redundant.

3) **Enforcement.** Enforcement of conditionality has been too weak. Hence, we would reiterate our proposal that new financial assistance would be cut off if a country did not live up to its commitments. A continuing breach of conditions should lead to cut-offs from structural funds and, in the event, from the euro area's money market, as the public debt of the offending country should no longer be eligible as collateral for ECB funds under a repurchase agreement (which implies that there would be capital and exchange controls). Emergency lending assistance to banks by national central banks should be abolished.

4) **Orderly default.** In line with our earlier proposal, we think that a country should restructure its public debt if the size and length of the adjustment programme is not enough to bring the country back to the market. The Brady bond model and the Greek version of it still seem appropriate to us, and we continue to think that the size of the haircut should be such that the debt ratio of the country in question declines to the Maastricht limit of 60%. In return for exchanging bad debt against safe debt, the EMF should receive all claims against the defaulting country. From that time onwards, any additional official funds the country received could be used only for specific purposes approved by the EMF. Other EU transfer payments would also be disbursed by the EMF under strict scrutiny, or they could be used to pay down the debt owed by the defaulting country to the EMF.

5) **Exit.** If both financial assistance and debt restructuring failed to create financial stability and the respective country were cut off from all further assistance from the EMF, it should be able to reintroduce its own currency, exclusively or in parallel to the euro, without having to leave the EU. The above regulation of structural funds and other EU transfers would still apply (see also Appendix 2).

The European Commission recently published its own proposal of a European Monetary Fund. It differs from our scheme in several respects: First, the Commission proposal introduces a "reinforced qualified majority" voting procedure to speed up decisions. We are not aware that the existing voting procedure prevented timely assistance when needed. Second, the Commission intends to establish the EMF as a Community institution with strong Commission involvement instead of an intergovernmental institution. In our view, this is inconsistent with the character of the EMF as a non-political institution and the Commission's declared intention to be "political". Third, the Commission wants to develop new financial instruments within the EMF. We do not see a scarcity of Community financial instruments and prefer a clear focus of the EMF. Fourth, the Commission proposal omits a sovereign debt restructuring and EMU exit scheme. We believe both are necessary as error correction mechanisms in a world governed by uncertainty. The Commission also wants to have the EMF act as a common backstop to the Single Resolution Fund (SRF). We would find it consistent with our model of the ESM as a lender of last resort for official entities, including the SRF. In a large crisis it is likely that many assets are underpriced, and hence it is likely that the SRF would be able to repay a loan from the EMF not only from future fees of banks but also from profits on bank assets it has acquired in the crisis.

Our revamped outline for the EMF would strengthen incentives for establishing sound public and private finances in EMU member states and reduce the need to rely on the ECB in maintaining the EMU. It would also respect the principle of no bailout still enshrined in the Treaty on the Functioning of the European Union much more clearly than the present arrangements (which have been subject to numerous legal cases). Nothing in life is irreversible, not even entry into the EMU, and defaults on promises to pay are a fact of life in a market economy. If one accepts this and prepares for the consequences, the ECB would no longer be needed as a quasi-fiscal agent and could concentrate on its original mission, namely to issue money with a stable purchasing power (or 'inner value') for the citizens of the monetary union.

6. Concluding considerations

The successful rescue programmes of the ESM have shown the value of having a lender of last resort for solvent, but illiquid governments. The case of Greece has also shown that solvency and liquidity are very hard to distinguish.

In concluding, we would like stress another consideration that emerges from the euro crisis. When the financial system of the entire area is in danger governments feel that they have no choice but to bail out even governments that are very likely to be insolvent. Moreover, they and the EU institutions will even pressure national governments to accept a bailout in order to limit financial instability. This makes it difficult to impose conditions and increases the political costs for both creditors and debtors, as both feel that they are not acting in their own interests.

Our central consideration is thus that the key purpose of an EMF should be to ensure the stability of the financial system of the euro to limit the negative spill-overs from the potential financing difficulties of any individual member state (see Tirole, 2015 and Farhi and Tirole 2017). This is essential, not with the punitive intent of 'establishing market discipline', but to ensure a proper alignment of responsibilities: the Union should not have to bear the cost of excessive debt accumulation of member states, which ultimately remain sovereign in their fiscal policies (see Schäuble, 2017).

Member states will face the proper incentives to reduce their debt to sustainable levels only if they know that the Union is not forced to bail them out. Since contagion is the way financial crises spread, this implies that an EMF should have ample facilities to protect the 'innocent bystanders', i.e. countries whose finances are sustainable, but which might suddenly experience financing difficulties because investors withdraw from an entire group of countries. Another way financial crises spread is via the banking system. It is therefore critical that the unsustainable debt of a government does not put the euro area's banking system into difficulties. This is of course the purpose of the Banking Union, but given that the resources of the Single Resolution Fund are limited, it might be useful to clarify that in case of a large crisis the Union will stand behind the institutions of the Banking Union. In other words, in the existing credit money order, the Banking Union eventually needs a fiscal backstop (or the money order would have to be changed).[7]

A financial stability mechanism is thus essential to ensure that a bailout is no longer "*alternativlos*" as Chancellor Angela Merkel used to say. The EMF should create the possibility to decide whether to grant financial support to a country that cannot roll its debt because it has lost market access. It makes a world of a difference whether, as in 2010, both sides feel condemned to a bailout package that neither side likes, or whether there are alternatives. Whether the debt of a country is sustainable is rarely known with any certainty beforehand. Accordingly, it is proper that the Union, in the 'spirit of solidarity', initially gives a country the benefit of the doubt and provides financial support for an adjustment programme. But the exposure of the Union should be limited. If the programme goes awry, a cut in the debt must be considered dispassionately. The EMF could be of great help even if this has become unavoidable, as it could provide bridge financing and a framework for negotiations between the creditors and the debtor country.

[7] Banks are licensed to create book money by extending credit. Thus, book money is a private liability of banks to their customers and is destroyed if banks fail due to credit losses. Deposit insurance was created to protect book money from bank failures. A fiscal backstop is needed in case of systemic banking crises. However, in the euro area the strength of government finances varies among countries, and so does the quality of national deposit insurance schemes and hence the quality of book money. Without a common fiscal backstop for deposits created through credit extension, EMU is no more than a cash union. There have been suggestions to change the money order to increase stability (see e.g. the 100% money concept of the Chicago plan of the early 1930s), but this is unlikely to happen.

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Appendix 1. A standstill for debt service during the adjustment programme

It appears very difficult to limit European Stability Mechanism (ESM) financing for a country with high public debt when the country's debt has not been judged unsustainable at the beginning of a programme. Consider the example of a country with a debt-to-GDP ratio close to 140% and an average maturity of seven years. With this combination, about 60% of GDP will have to be refinanced over the first three years of a potential ESM programme. To this one will almost surely have to add some current deficits, which over three years could easily add another 10% of GDP. The initial programme could thus require 70% of GDP.

But this will lead to a situation in which there will be little room for any haircut, should the programme not succeed in restoring growth and hence external and fiscal balance. Very short-term debt, which is almost never subject to a haircut, typically amounts to about 15% of total debt, and would in this case likely be worth 20% of GDP.

The banks of the country concerned might hold another 20% worth of GDP in bonds. This debt cannot be cut either, because that would destroy the financial system of the country (and any chances of success of the programme).

On top of this, one has to consider any holdings of home country public debt by the national central bank. The bonds held by the central bank (acquired for example, under the Public Sector Purchase Programme of the ECB) might be formally subject to a haircut (as long as the national central bank does not hold a blocking minority). But this does not help because the national central bank is part of the national public sector and any losses it incurs could fall back on the government anyway.

The remaining 'haircuttable' debt could consequently be reduced to only about 20-30% of GDP after three years of a programme. The general corollary to these illustrative calculations is that there might be little room left if a highly indebted country is fully refinanced even over only a few years.

Something along these lines was also the case in Greece, where officially €200 billion in debt instruments could be made subject to the private sector involvement (PSI) operation. Very short-term debt (and that held by the ECB) was excluded. But the holdings of the Greek banks (and insurance companies) comprised a large part of the €200 billion and they had to be refinanced by the ESM in order to keep the Greek banking system afloat. Only about €100 billion of bonds still held by international investors were effectively subject to the PSI, which reduced them in nominal terms to about €50 billion, resulting in a gain of about 25% of GDP. This is actually somewhat better than what one would expect in the example above: the country would start with a debt ratio of close to 140%. If 30% remained available for cutting this would yield a potential gain (in nominal terms) of about 15% of GDP, or a new debt ratio of 125% of GDP.

All these calculations were in terms of the initial GDP. But a country going into a deep crisis will typically experience, at least initially, a fall in GDP. Moreover, countries needing external financing tend to have lost competitiveness and will need an internal devaluation. This implies that, provided the rest of the euro area sticks to price stability, nominal GDP might have to fall considerably before growth resumes. If nominal GDP has to fall by 20% the debt ratio at the end of the adjustment process would be 125 * 1.2 or 150% of GDP.

These considerations suggest a number of policy conclusions:

- There would have to be a standstill for debt service payments when a programme is launched for a country with very high initial debt (this was not the case for Spain or Ireland).
- Countries with high debt ratios should be induced to have longer average maturity. (Government) debt management is considered a purely national prerogative. Yet in a crisis the structure of public debt becomes a key issue for the entire area. The incentives are therefore not properly aligned: in the run-up to a crisis the country usually starts issuing shorter-term debt because it wants to avoid locking in high-risk premia for a long time. If everything goes well this will have been the right choice. However, if the crisis deepens and the ESM has to intervene, the risk will be transferred to the euro-area taxpayer.
- Banks should not be allowed to hold large amounts of the debt of their own government. This would be in the interest of their country, as substantial holdings of government debt could lead to EMU exit in the case of a restructuring of government debt (see Appendix 2).

  Finally, more thought should be given to how to measure public debt ratios. Any overvalued domestic price levels should be taken into account in assessments of debt sustainability. Accordingly, we propose to limit access to ESM funding in the way described in the main text. Table A1 provides an illustration of the resulting access limits.

Table A1. Access limits, based on a multiple of actual ESM quotas

	ESM quota (€ bn)	€ bn	% GDP	Actual total financing received as a % of the access limit
Germany	134.8	404.4	12.9	–
France	101.2	303.7	13.6	–
Italy	89.0	266.9	15.9	–
Spain	59.1	177.3	15.8	23.3
Netherlands	28.4	142.0	20.2	–
Belgium	17.3	86.3	20.4	–
Austria	13.8	69.1	19.8	–
Ireland	7.9	39.5	14.4	170.7
Finland	8.9	44.6	20.7	–
Portugal	12.5	62.3	33.7	125.2
Greece	14.0	69.9	39.7	371.8
Slovakia	4.1	28.6	35.4	–
Luxembourg	1.2	8.7	16.4	–
Slovenia	2.1	14.9	37.2	–
Lithuania	2.0	14.2	36.5	–
Latvia	1.4	9.6	38.4	–
Estonia	0.9	6.5	30.8	–
Cyprus	1.0	6.8	35.9	92.4
Malta	0.4	2.5	25.7	–

Note: Total financing includes IMF assistance (and for Ireland third-country contributions).

Source: Own calculations based on AMECO data and the ESM.

Appendix 2. Extreme scenarios: Could restructuring lead to exit?

Consider again a highly indebted country, where domestic banks hold government bonds in an amount equivalent to or larger than their equity. In this case, a haircut on the outstanding debt could push banks' equity capital below the regulatory limit, in turn requiring a combination of recapitalisation and bail-in under the rules of the Bank Recovery and Resolution Directive (BRRD). In principle, the Single Resolution Fund would be available for funding the recapitalisation. But this is likely to be difficult because the economy of the country in question would probably be in a deep recession and the required bail-in might be very large. Hence, it is likely that depositors might also face some haircut. The final result would be that depositors would lose part of their money, as the government would lack the funds to back deposit insurance.

At the same time, the national central bank might end up with negative capital if it still had large amounts of government bonds on its balance sheet (e.g. those acquired under the Public Sector Purchase Programme of the ECB). If holdings by the national central bank are not cut, the losses the other bond holders have to take will increase.

Some losses for (domestic) depositors might thus be unavoidable. However, the country in question can still choose what forms these losses take.

If the country remains in the euro, capital controls would become necessary and the losses of bank creditors would follow the BRRD rules – with holders of bank bonds and large depositors experiencing near total loss and some more moderate losses for smaller deposits (those below €100,000).

The alternative would be to exit the euro and lower the real value of existing deposits (and other bank liabilities) through a combination of devaluation and inflation. This could be done in two ways: i) unilateral default through redenomination of all euro debt, or ii) mutually agreed debt reduction via redenomination.

A country opting for the first way would face the wrath of its private and public creditors. Fortunately, the times when such wrath led to military action are over, but the country would immediately become a pariah in political, economic and financial affairs. Of course, EU membership and any benefits going with it would immediately end. No rationally thinking administration would choose this way, but it cannot be completely excluded. It could happen, if political decision-makers acted irrationally, miscalculated or for any other reason failed to take the steps needed to prevent the catastrophe.

A country could go the second way if its political leadership and its creditors mutually agreed that even after debt restructuring continued membership of the EMU would not be viable. The case of 'private sector involvement' in Greece, where the debt to private investors experienced a haircut by nominally 53.5%, showed that such agreement is possible, when both the debtor and the creditors believe that this is the best way forward for both sides.

Public creditors acting in good faith should be able to act accordingly (which, unfortunately, they failed to do in the case of Greece).

Debt reduction through redenomination of course only makes sense when countries suffer from an ingrained loss of competitiveness on top of insolvency. Experience has shown that a nominal devaluation might be easier and quicker than an 'internal devaluation' through a cut in nominal wages and prices. Exiting the euro, coupled with a large devaluation, might provide a boost to the economy and indirectly strengthen the banking system. In the case of Greece, the discussion about exit occurred, but it was years after the start of the programme when domestic prices and wages had already fallen by over 20-25%, thereby eliminating most of the competitiveness gap that had been identified initially. This is why it should not be excluded as an option beforehand.

The choice of whether or not to exit the euro should thus not depend on the size of the public sector debt overhang (which can be dealt with by debt restructuring within the EMU), but rather on the need for an improvement in competitiveness. (We concentrate here on the economic considerations. Exiting the euro is obviously a measure of the highest political importance and political considerations might override economic ones.)

At any rate, even if euro exit is agreed by all sides as the best way forward, the common currency could still play a key role through the establishment of a 'safe euro deposit' at commercial banks, where the euro deposits of customers would be fully backed by the reserves that banks hold at the ECB. Thus, the euro could also be used for non-cash payments in addition to its use for cash payments. The country would remain in the EU and its residents would have the option to continue to use the euro as a means for cash and non-cash payments and as a store of value, keeping open the way for a return to euro-area membership.

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