GERMAN COUNCIL
of Economic Experts

The European Redemption Pact (ERP) - Questions and Answers

German Council of Economic Experts

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1. Why are the resolutions taken at the 9 December 2011 summit not sufficient?

The EU summit in December 2011 resolved among other things to introduce a fiscal compact that would initiate the reduction in excessive sovereign debt. This laid the central foundations for solving the debt crisis. However, we cannot exclude individual EMU member states in the future getting into refinancing difficulties until financial markets have been convinced that the agreed consolidation process is being upheld.

The interest rates for some Euro-Area member states have already risen sharply, reflecting the great degree of uncertainty in the financial markets. Given the herd instinct, an abrupt loss in market confidence can swiftly turn into a “self-fulfilling prophecy” among investors. The massive surge in interest rates thus triggered then actually calls into question whether the public debt of the country in question is actually sustainable. We cannot therefore exclude financing terms for some EMU member states deteriorating further, despite having undertaken credible and essentially appropriate reforms.

In the extreme case, such a country may no longer be able to refinance outstanding bonds in the international financial market, and a liquidity crisis could then turn into a solvency crisis. We therefore fear that in the absence of a European Redemption Pact (ERP).

(a) the ECB would in response have to buy up government bonds on a far larger scale than hitherto,

(b) the EMU member states would have to agree, as it were overnight, to unlimited joint financing through Eurobonds,

(c) the Currency Union would break up in an uncontrolled manner.

The German Council of Economic Experts rejects each of these three alternatives (AR 2011, items 172ff.) and has therefore put the “European Redemption Pact” up for debate as a possible way out of the crisis (AR 2011, items 184ff.).

2. What are the goals of the ERP?

The ERP is designed to function as a bridge to a long-term stability structure in which an effective government insolvency regime obtains (AR 2011, items 245ff.). In such a regime, market discipline functions pre-emptively by preventing debt quotas from exceeding 60 % of GDP – instead of functioning destructively and only after the event, as is the case now. A precondition for instituting an insolvency regime is however that excessive government debt in all countries be reduced to below 60 %. For this reason, the ERP contains the clear, long-term and credible commitment by all participating countries to reduce debt.

3. How does the European Redemption Pact work?

The proposal envisages that EMU member states' debt exceeding the 60 % ceiling on a certain date be transferred into the ERF for which the EMU members are jointly and severally liable. In return, the participating countries would enter into payment obligations toward the ERF that are calculated such that each country would repay its transferred debts within a total of some 25 years. To make this time constraint binding, the possibility to take advantage of obtaining lower financing costs for the transferred debt will be associated with strict conditions. In particular, these conditions comprise earmarking/devoting a part of the tax revenue for fulfilling the payment obligations, depositing collaterals and the obligation to commit to consolidation and structural reforms.

The remaining national debt must thereafter not again exceed a level of 60 % of gross domestic product (GDP). To this end, debt brakes would be introduced in all participating countries based on the German and Swiss models. The debt cap implements the medium-term debt regulations set out in the Stability and Growth Pact. In particular, they ensure that, following a transition period, the structural deficit does not exceed a value of 0.5 % of GDP.

4. Why are of all things the debts that lie above the 60 % of GDP mark transferred?

The proposal's goal is to reduce the debt issued by the respective countries to the level set in the Maastricht Treaty by 2016, which is exactly the 60 % envisaged.

5. What is the relationship between the ERP and the intensified SGP and the summit resolutions on the fiscal compact made on 9 December 2011?

The central parameters of the ERP are consistent with the deficit and debt rules of the intensified Stability and Growth Pact and the proposal for a fiscal compact of 9 December 2011. Moreover, the fiscal compact calls for implementation of national debt brakes as is already envisaged in the ERP. As regards reducing debt ratios, the stipulations set at the EU level call for annual reduction by $1/20^{th}$ of debt that exceeds the target level of 60 % of GDP.

The limitation of the ERF in time to a total of some 20 to 25 years along with the condition that following the roll-in phase national debt (outside the fund) no longer be allowed to exceed 60 % enhances the binding effect of the $1/20^{th}$ rule. The interest-rate advantage that arises in particular for the highly indebted countries by transferring debt to the ERF additionally supports the agreed upon binding reduction in debt. The ERP would therefore meaningfully support the initiatives at the EU level, and furthermore it would counter possible liquidity crises that could arise during the required consolidation in coming years.

6. Who participates in the ERP?

Participation is open to all Euro-Area countries which are not yet running a structural adjustment programme. Unlike the EFSF, the ERP is a pre-emptive instrument. At the very least, those EMU member states should take part whose debt ratios exceed a level of 60 % of GDP. At present, these would be Austria, Belgium, Cyprus, Germany, France, Italy, Malta, the Netherlands, and Spain. Countries that are currently running a structural adjustment programme can join the redemption pact immediately, but their debts can only be transferred to the redemption fund after the successful conclusion of the respective adjustment programme.

7. How does transferring the debt function?

In the beginning of the ERP a firm sum in euros for the debt each country can transfer is contractually agreed. There have to be conditions in the contract that rule out that this sum cannot be increased subsequently. The ERF issues its own bonds in order to cover the participating countries' refinancing requirements. This continues until the maximum transfer volume for all countries has been reached. During this so-called roll-in phase, the participating countries fulfil the consolidation and reform agreements likewise fixed in advance, as with the EFSF's structural adjustment programmes. Debt transferring is immediately stopped if a country does not meet its contractual duties under the ERP.

During the roll-in phase, the French, Italian and Belgian financing requirement is presumably covered for 3 to 5 years. Germany, Spain, the Netherlands and Austria would also have to partly finance their debt in the financial markets and under their own national responsibility already during the roll-in phase. The actual length of the period depends on the current debt level ratio and the term structure of a country's existing sovereign debt.

8. Will debt redemption involve direct transfer payments?

No. The payments to the ERF serve exclusively to repay the debt transferred by a particular country and the related refinancing costs. Countries that transfer more debt have to make higher payment-obligations to the fund. However, the joint and several liability means an alignment of the refinancing costs. Compared with the current situation there may thus be more or less of a burden placed on the individual countries.

9. Is it guaranteed that the lower interest rate of the European Redemption Pact does not undermine the consolidation efforts in the problem countries?

Yes. The joint and several liability means that many countries will enjoy advantageous interest rates for the transferred debt. The national debt brakes together with the binding consolidation plans ensure that this advantage is used to support budget consolidation and not for extra government spending. After the roll-in phase, the countries then have to take up refinancing exclusively in the financial market, which means market discipline can once again have an ex-ante disciplining effect. Moreover, one cannot assume here that interest on the nationally issued bonds will return to the historically low levels of the past for countries with very high debt ratios. Rather, we can expect that while current conditions will calm down, there will nevertheless be an interest-rate differential between the countries, meaning that after transferring the debt the pressure remains on them to press ahead with consolidation and adhere to the national debt regulations.

10. What refinancing costs can be expected for the ERF?

It is hard to gauge the financing costs for the ERF exactly because a new bond class is being created and it is hard to assess how the financial market will receive it. As regards a bond's yield, alongside other factors, in particular the following two are of relevance: (1) probability of default and (2) the bond’s liquidity.

We can draw on the yields of bonds issued by the European Investment Bank (EIB) or the European Financial Stability Facility (ESFS) as a reference point for possible yields on the ERF bonds. Both asset classes come with extensive government guarantees. For ten-year bonds, these two institutions currently pay interest rates of around 3.0 % and 3.3 % respectively (as at 23 Jan., 2012). For the two reference bonds (EIB, EFSF) the default probability can be considered comparable to that of the bonds to be issued by the ERF. With respect to the EFSF, it bears remarking that only partial liability is involved, and thus there is a somewhat higher default probability than under joint and several liability.

Market liquidity for ERF bonds would presumably be higher than that for the two reference bonds. The impact of a more liquid market on the yield can be best estimated by comparing the yields between the bonds issued by the Kreditanstalt für Wiederaufbau (KfW) and the far more liquid Bunds. Ten-year paper issued by KfW is currently trading at about half a percentage point higher than the Bunds despite the identical default probability. The liquidity advantage for the ERF bonds will probably be on a similar order.

In light of these (simplifying) considerations, financing costs can be expected to fall within a range of around 2.5 % to 3 %. However, higher yields also seem possible given market uncertainty at present. Yields above those on bonds issued by EFSF (around 3.3 %) seem improbable, however.

11. What additional burden will Germany have to shoulder owing to the joint and several liability?

During the current crisis, Germany is enjoying lower refinancing costs: The yields on 10-year Bunds are currently at 2 %, which is well below a “normal level”. A joint and several liability on the transferred part of the debt would therefore lead to additional costs, because refinancing costs for the ERF would presumably be above those Germany currently has to pay (see Question 10). In addition, refinancing costs for Germany could be influenced by changes in the financing costs for the part of debt, that remains a matter of national sovereignty.

The clear premium on yields on bonds issued by European institutions such as the EFSF or the EIB compared to German Bunds is presumably in part attributable to a “currency risk” that reflects the worries regarding a break-up of the Euro-Area. In such an extreme scenario there is the risk that the bonds issued by both institutions would be serviced by different currencies, namely the newly introduced national currencies some of which would devalue immediately after a break-up of the Euro-Area.

In the case of the German Bunds, by contrast, the most probable consequence would be that the repayment would be in the new German currency which would previously have been considerably revalued. To a certain extent, this explains the current willingness among investors to accept negative yields on short-term Bunds.

Should these worries be dispelled by a credible long-term solution, such as the ERP, we can expect that German yields will rise. After the ERP is established, the bonds issued by the ERF would be comparable to Bunds in terms of both liquidity and default risk, and there would be no notable “currency risk” left. Germany’s refinancing costs would thus probably rise to a comparable level, i.e., between 2.5 % and 3 % (see also Question 10).

12. How high are the annual payment-obligations to the European Redemption Fund?

The scale of annual payment-obligations will relate to the volume of transferred debt. In the first year, the country bears the pro-rated interest payments by the redemption fund on its transferred debt and, moreover, pays a sum of 1 % of the transferred debt for the redemptions. This first allocation is pegged to GDP. The ratio this gives is in future used to calculate the payment-obligations. It will rise with the debt-to-GDP ratio. With economic growth, the payment-obligations rise in absolute terms over the course of time.

Example: After conclusion of the roll-in phase, Italy would transfer to the debt redemption fund a total of 60 percentage points (120 % – 60 %) of it sovereign debt ratio. Calculating the annual payment-obligations starts from this total. Were the redemption fund to refinance itself at interest of 4 %, Italy would in the first year have to make payments of 0.6 x 0.04 for the interest and 0.6 x 0.01 for the redemption. This share of 3 % of GDP would thereafter remain constant. Given GDP of EUR 1.6 trillion in 2011 this would spell an allocation of EUR 48 billion. Assuming a nominal GDP growth rate of 3 % (which corresponds to real growth of 1-1.5 %) Italy would have repaid its debt in the debt redemption fund after 23 years. With lower growth rates, the redemption period would be longer. However, the assumption of a nominal GDP growth of 3 % is already very modest if compared to historical data.

13. What is the difference between ERP-proposal and the Eurobond idea?

The debt assumed by the ERF is from the outset limited in both time and volume. With each redemption payment to the ERF, the volume of bonds guaranteed jointly and severally decreases, meaning that the fund slowly abolishes itself. Nation states are themselves responsible for financing their current deficits through the market after completion of the roll-in phase. Unlike this, Eurobonds are permanent in character and their volume is not limited.

14. What is the difference to the Delpla/Weizsäcker proposal (blue bonds / red bonds)?

The Delpla/Weizsäcker proposal is neither constrained in time nor in volume. It envisages to float debt under joint and several liability for up to 60 % of the national GDP (blue bonds). For debt that exceeds this, the member state would alone be liable (red bonds). The split between debt for which a country is liable and debt for which there is joint and several liability is exactly the opposite of that in the European Redemption Pact. In contrast, the assumption of the ERP is that participating countries are able to redeem the excessive debt, even if this may be a challenging task. Debt redemption is therefore at the centre of this proposal. The ERP neither prepares nor envisages the introduction of Eurobonds, as is the case of the blue/red-bond proposal which aims at financing the “healthy core” of the debt under several and joint liability.

One disadvantage of the Delpla/Weizsäcker proposal is that the "excessive" debt, i.e., that which exceeds the debt ratio of 60 %, is very poorly secured, meaning that countries remain prone to a sudden collapse in refinancing sources. The proposal does not therefore offer a solution to the liquidity problem. Moreover, joint and several liability is limited neither in time nor in volume. A return to exclusively national liability is therefore impossible in this model. Likewise, there is no mechanism to reduce debt ratios to a figure of 60 % over a foreseeable period. Precisely the return to exclusively national liability and the reduction in debt to below the value of 60 % of GDP is the goal of the European Redemption Pact.

15. How high is the maximum volume of the European Redemption Fund?

The overhang of debt existing at the end of 2011 and exceeding the level of 60 % of GDP determines the scale of debt to be transferred. This amounts in total to around EUR 2.3 trillion. The lion's share is attributable to Italy, with EUR 958 billion, followed by Germany (EUR 580 billion), France (EUR 498 billion), Belgium (EUR 136 billion) and Spain (EUR 88 billion), Austria (EUR 41 billion), the Netherlands (EUR 24 billion), Malta (EUR 0.5 billion) and Cyprus (EUR 0.4 billion). It bears noting, however, that budget conditions in some countries, such as Spain, will prevent stabilization of the debt level ratio in coming years. They will therefore book debt ratios at the end of the roll-in phase of over 60 % (excl. the transferred debt). It bears considering possibly allowing these countries a slightly higher transferring volume so that they do not have alongside the payments to the ERF to also reduce non-transferred debt.

16. What life span does the European Redemption Fund have?

Payments to the European Redemption Fund are calculated such that each country repays the debt it has transferred over about 20-25 years. Regarding the life span, a degree of uncertainty remains as payments to the redemption fund are defined as a ratio of GDP. The exact duration of the repayment thus depends on average economic growth over the next 25 years. It is in principle possible to agree faster or slower redemption from the outset. The goal of reducing the debt rate to 60 % can not be achieved in less than 20 years assuming realistic primary balances in the highly indebted countries.

17. Is it realistic to reduce the debt ratio over a good 20 years to 60 %? Are the corresponding consolidation requirements not too high?

The period for reducing debt ratios to 60 % is sufficiently long to ensure that the primary surpluses necessary will not become unrealistically high. Italy would face the highest primary surplus necessary, namely a little more than 4 %. The central consolidation objectives related to the ERP are in line with those of the Stability and Growth Pact and the foundation of a fiscal compact as resolved by the EU governments (with the exception of the United Kingdom) on 9 December 2011. There will be no extra burden compared to current budget planning by the Italian government, but the binding commitment will be greater.

18. After the introduction of the ERP will there still be a need for the EFSF/ESM?

Yes. The EFSF and later the ESM remain responsible in the interim for the financing of Ireland, Greece and Portugal. These institutions could in future come into play if there are severe liquidity or solvency crises, or if the banking system is in need of support. Thus, the EFSF or at a later point the ESM would be a crisis mechanism open to ERP members in future crisis situations. The ERP does not therefore replace these institutions.

19. Is partial liability possible?

In principle, the ERP could also be based on partial liability with overcollateralization. However, experience with the EFSF shows that the markets view such structures very critically. A possible downgrade on the creditworthiness of the countries that have signed up would threaten the prime rating of ERF bonds. A structure featuring joint and several liability with a loss allocation key thus seems more sensible. This would create a new safe asset class, which, given its prime rating, would presumably help steady the financial markets.

20. What happens if a country does not stay on consolidation track? Would the stable countries then have to pay for the weaker countries' debts?

No. Unforeseen deficits such as could arise, for example, owing to a clear slow-down of the economy would have to be financed under national responsibility through the market. Since relative to the total refinancing requirement far smaller sums would presumably be involved, high interest rates would be less problematic in such a case. If financing through the capital market is nevertheless not possible, then a potential solution would be to peg financing for the excessive deficits to an adjustment programme via the EFSF/ESM and the IMF.

21. What flexibility does the proposal offer in the event of unforeseen shocks?

The annual payments to the ERF are expressed as a fixed ratio of the respective country's GDP. In the event of a severe economic downturn in a country, it would then repay somewhat less debt in absolute terms and more in the case of an upturn. Moreover, a shock to a given country would have to be absorbed by taking up debt in the financial markets to the extent that this is within the limits of the debt brake. Should this not suffice, then bringing in the IMF together with the EFSF or later the ESM would have to be considered.

22. What collateral mechanisms are envisaged to prevent a case arising where liability comes due?

Countries wishing to participate in the ERP have to commit to nominate collateral that is pledged specifically to cover the payment-obligations made to service their own debt in the ERF. For example, to this end, specific taxes (potentially to be introduced) could be specified that are used to service the payment-obligations. Analogously to the Solidarity Surcharge in Germany it would thus be conceivable for the respective countries to raise a surcharge on a tax that they would themselves choose for the purpose. Another version discussed in the Council's Annual Report 2011 would be to pledge to the ERF assets totalling up to 20 % of the transferred debt as collateral; the assets could be taken from the country's currency and gold reserves. The collateral nominated would only be used in the event that a country does not meet its payment obligations, thus lowering the risk that the other countries are made liable.

23. Will the collateral be "pooled"?

No. Each country must hedge its own payment obligations that result from its own debt transferred to the fund by furnishing collateral, e.g., in the form of currency reserves. Thus, if the currency reserves or other collateral are pledged, these do not get "pooled", but are instead a partial "insurance" against liability for the partner countries in the ERP. For this reason, here, the German currency reserves would not, for example, be drawn on as liable assets for Italian debt. Italian reserves would exclusively serve as liability for Italian debt, and German reserves for German debt.

24. How to prevent an expansion of the ERF over time or in volume?

The debt to be financed through the ERF is limited to a specific sum. It is crucial when structuring the pact that any expansion be excluded in all events. Therefore, Germany's agreement to an expansion or perpetuation should be pegged as a precaution to Article 146 of the German Basic Law. A constitutional change would therefore be necessary as greater liability would affect Germany's financial independence. Likewise there can be no questioning the scale of the payment-obligations. Adherence to the consolidation track is also a precondition for continued transferring of the debt (conditionality).

25. What happens if a country does not meet its commitments to the ERF?

If a country does not meet its payment commitments, the collateral furnished by each country could be taken up (see Question 22). Thus, at the beginning payments would be secured for 3 to 4 years, or for longer if a part of the transferred debts has been redeemed. Joint and several liability would then only come into play if all the collateral furnished by the defaulting country has been used up. This would however imply that a country has declared state bankruptcy because selective servicing of the creditors would be very difficult if at the same time payments to the ERF were discontinued. This would, in particular, apply if a country should try to service claims by international lenders, as the payments would have to be settled through the inner-European payment systems and could theoretically be intercepted. Should an ERP member thus declare state bankruptcy, the remaining member countries would have to shoulder the payment-obligations for the defaulting country. The portion to be borne by each country would be defined by a distribution key put in place when setting up the ERP. One possible such key would be each country's pro-rated proportion of the total ERF volume. If the portion were instead pegged to economic power, membership of the fund would be unattractive for those countries that only finance relatively minor sums through the ERF (e.g. the Netherlands, Austria).

In the final instance, even if a case of liability arises, it would still be possible for a country to return to financial stability and at least resume on-going payment-obligations, or even to indemnify the other countries for payment-obligations these had already assumed for it. Since the country in question will in future continue to depend on the willingness of its European partners to cooperate with it, it is unlikely that there will be an event of complete payment default and thus complete liability having to be assumed by the other countries.

26. Does the ERP require a change in the EU treaties or can it be structured as an international treaty?

Structuring the ERP as an international treaty should suffice if not all EU member states are prepared to participate. The countries signing up would have to commit in the treaty to introduce debt brakes, enter into payment commitments to the ERF, and to put up collateral for these commitments.

27. Can countries in distress not bear their debt themselves in the long term given current high interest? Is the ERP really necessary?

In the long term, sovereign debt, for example in Italy, will hardly be feasible to bear given the on-going high interest rate of 7 %. At that interest rate and assuming a growth rate for nominal GDP of 3%, which (in line with the ECB's inflation band) corresponds to real growth rates of 1-1.5 %, Italy would need an annual primary surplus of about 8 % to achieve the reduction in debt ratio foreseen under the terms of the ERP. That would be almost unprecedented as to date only very few countries have managed to post primary balances in the order of 5 % for a longer period.

28. The countries in distress are indebted in the long term at fixed terms. Given such conditions, will they not manage to consolidate under their own steam?

There are at present still good grounds for hoping that higher interest will only impact completely on the average interest rate on sovereign debt over the course of some years. However, in the short term there will also be a considerable excess burden placed on some government budgets. Compared to mid-2011, Italy would this year have to shoulder additional interest payments of a total of EUR 12 billion for refinancing all the bonds it has hitherto issued if current interest rates of 7 % prevail. A Structural consolidation on this scale must be achieved on top of all else. This means immense additional consolidation measures that are hard to accept politically, in particular as this means "putting aside savings" only to pay for the increased interest rate. Metaphorically, the country must "run faster" in order to manage to "stand still" in terms of the debt ratio. As a whole, the countries in distress are under extreme pressure to take up (re)financing at sustainable rates in the financial markets at very short notice.

This constellation may mark a consolidation dilemma. The risk premiums in the financial markets will only dwindle if the markets are convinced that governments have embarked on a sustainable consolidation track. This cannot be achieved immediately, however. If consolidation goes too fast and the economy goes into recession, achievement of the desired successful consolidation becomes highly improbable. Financing at appreciably more favourable conditions would then only be possible after an economic recovery. If instead the government opts for a slower debt reduction, this might avoid the economy slump but will also mean a longer time until consolidation successes restore market confidence. For a transitional period there is thus no excluding that despite a government being willing to consolidate, shared financing is still necessary.

29. Italy faced similarly high and in part far higher interest rates before joining the EMU. Why is the situation not comparable?

Whether debt is sustainable depends primarily on the difference between nominal growth rate and nominal interest rate. In Italy, because of past inflationary trends, this difference has regularly been more advantageous than it is today, with the current refinancing rate at 7 %. In phases when this difference becomes too great it is hardly possible to prevent the debt ration rising sharply. This was the case in Italy, too, where we have seen in part strong rises in the debt ratio during phases of high interest rates. The present situation in a currency union can hardly be compared with the economic situation in prior high-interest phases.

30. Where can I find additional information on the ERP?

A detailed description of the ERP can be found in the annual economic report 2011/12 of the German Council of Economic Experts. The respective chapter can be downloaded here. A short summary also appeared on voxeu.org.