GERMAN COUNCIL
of Economic Experts

CONSEQUENCES OF THE GREEK CRISIS FOR A MORE STABLE EURO AREA

Special Report

July 2015

This is a translation of the original report published in German, which is the sole authoritative text.

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FOREWORD

1. The cohesion of the common currency area seemed assured following the major reduction in interest rate spreads since summer 2012. However, the ongoing clash between the new Greek government and the Eurogroup since the beginning of the year has shaken the **foundations of the European Monetary Union** once again. As the negotiations currently stand, these developments signal a third extensive rescue package for Greece, holding out at least a chance that the country can overcome the crisis within the euro area. However, these events raise the urgent question whether the previous **reforms to the institutional framework** of the Monetary Union have been sufficient to prevent similar events in the future from threatening its existence again.

2. In recent years, the institutional framework has undergone major changes, most notably the creation of the European Banking Union and European Stability Mechanism (ESM). These emphasize the national responsibility of euro member countries for sound public finances and international competitiveness. Continuing on this path will necessitate **additional crucial reforms**. The banking union needs to be strengthened through further development of the resolution regime and establishment of integrated financial supervision. The privilege afforded to government bonds in banking regulation must be brought to an end. Consistent application of fiscal and insolvency rules for states is needed to reduce debt levels and make the **no-bailout clause credible**.

3. Short-term effective measures to tackle acute problems, such as the exceptions to the no-bailout clause in order to stem the crisis in Greece, harbour a serious long-term **threat to the stability** of the euro area. The same applies to reform proposals currently under discussion, such as establishing a fiscal capacity or European unemployment insurance. Sooner or later, the **transfer of individual member countries' liability risks** to the euro area as a whole will inevitably increase instability if not accompanied by a **transfer of national sovereignty** for economic and financial policy. However, there is neither the political will, nor any prospect of democratic legitimation for such a move.

4. For as long as member countries are unwilling to transfer extensive sovereignty for economic and financial policy, reforms to the framework cannot be justified solely by the desire to send **a positive signal** for European integration. Certainly, any changes to the euro area's existing architecture entail further risks. This is true, not least, of the idea for improving the stability of the monetary area by implementing explicit rules for state insolvencies. Weighing up the risks, however, this is far preferable to largely ignoring the problem of incentives for policymakers. Any alternative for the further development of the euro area that proposes increasing joint liability without a credible prospect of national sovereignty being transferred at the same time harbours far greater risks than the cautious introduction of a insolvency mechanism discussed in this report.

5. All reform proposals must ultimately withstand a critical examination of the incentives they offer for national economic and financial policy. The institutional

framework of the single currency area can only ensure stability if it follows the **principle of unity of liability and control**. Reforms that stray from this guiding principle plant the seeds of further crises and might damage the process of integration, despite their intentions.

6. These considerations have led the German Council of Economic Experts to submit a special report to the Federal Government in accordance with section 6 subsection 2 sentence 1 of the Act on the Appointment of a Council of Experts on Economic Development (*Gesetz über die Bildung eines Sachverständigenrates zur Begutachtung der gesamtwirtschaftlichen Entwicklung* – SachvRatG). It is entitled:

„Consequences of the Greek Crisis for a More Stable Euro Area“

One member of the council, Peter Bofinger, does not agree with the tenor of this special report and therefore presents a dissenting opinion.

Wiesbaden, 27 July 2015

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All errors remain our own.

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EXECUTIVE SUMMARY

1. The crisis in the euro area has revealed **fundamental problems** in the design of the single currency area. Firstly, there was a lack of economic and fiscal policy discipline. And secondly, there was no credible mechanism to respond to crises. These institutional deficits contributed to economic imbalances in the economically heterogeneous currency area, which made the economies of some member state vulnerable and contributed to the deepening of the crisis.

2. Given these developments, **macroeconomic adjustment** was unavoidable in the crisis countries. This included fiscal consolidation and structural measures to enhance competitiveness. These steps were associated with painful cutbacks affecting the populations of the respective countries.

3. To support the crisis countries in this process and stabilise their financial systems, **adjustment programmes** were agreed with the affected countries. Ireland, Portugal, and Spain all successfully completed their programmes. However, the lack of progress and recent turbulence in Greece have prompted voices to question the crisis response in its entirety.

4. Yet the situation in Greece should not be taken as proof of failure of the **rescue policy** as such. Firstly, the crisis response averted a systemic crisis and thus maintained the cohesion of Monetary Union. Secondly, the time was used to implement reforms to make Monetary Union more resilient against economic crises. Thirdly, the economic situation in Ireland, Portugal, and Spain has improved markedly.

5. It has become evident in the past years that the euro area member countries are overwhelmingly **unwilling to give up national budget autonomy**. To provide a stable framework for the Monetary Union based on the principle of unity of liability and control, the German Council of Economic Experts has developed a long-term framework (“**Maastricht 2.0**”, see Annual Economic Report 2012 paragraphs 173 ff.; Annual Economic Report 2013 paragraphs 269 ff.).

   In recent years, **major reforms of the institutional framework** have been implemented which largely reflect the “Maastricht 2.0” idea. Among other things, these put emphasis on the national responsibility of euro member countries for sound public finances and international competitiveness.

6. Nevertheless, some of these reforms remain incomplete. The **banking union** needs to be strengthened through enhancement of the resolution regime and establishment of an integrated financial supervisor. The problem of the **bank-sovereign nexus** has yet to be fully solved. The privileged status of government bonds in banking regulation must therefore be phased out and the discretionary leeway of creditor bail-in rules reduced.

7. The crisis policies induced the **ECB to assume the role of crisis manager**. This sends the wrong signal as regards fiscal consolidation. Yet, the only way to address the legacy of high public debt ratios is strict adherence to **fiscal rules**.

8. For the no-bailout clause to become credible, an **insolvency mechanism** needs to be created that requires a maturity extension of government bonds as part of future adjustment programmes if public debt is not deemed sustainable. In the event of over-indebtedness or a material breach of fiscal rules, an ESM adjustment programme should only be approved after a debt haircut is imposed on private creditors. If a member country continually fails to cooperate, the stability and very existence of Monetary Union may be at risk. A country's exit from Monetary Union must therefore be possible as a **last resort**.

9. In contrast to these reforms, short-term measures to address acute problems harbour a serious long-term threat to the stability of the euro area. This also applies to reform proposals currently under discussion, such as establishing a fiscal capacity or a European unemployment insurance. The institutional framework of the single currency area can only ensure stability if it follows the **principle of unity of liability and control**. Reforms that stray from this guiding principle plant the seeds of further crises and may damage the process of European integration.

I. INTRODUCTION

10. Since the formation of a new government in Greece in January 2015, the **Greek crisis** has dominated debates on economic and European policy. The second bailout package expired in June after Greece failed to reach agreement with its creditors. Greek banks were forced to close and capital controls introduced. Many Greek citizens are in a precarious economic position. Although the previously negotiated bailout was rejected by a large majority in a referendum, the euro-area heads of state and government initiated a **new, more extensive three-year bailout package** in a difficult negotiation process.

Events in Greece have, however, cast doubt on the **rescue measures** in response to the euro crisis thus far, throwing a further bailout package for Greece into question. A Grexit is not out of the realms of possibility.

11. In the opinion of the German Council of Economic Experts, the turbulences of recent months and future challenges to the stability of the Monetary Union create a need for **further development of the institutional framework**. Although no direct contagion effects occurred, through the financial markets or otherwise, the threat of a potential exit by one member country may have already changed the nature of the Monetary Union and thus have negatively affected other members. This could have economic and political consequences for Germany.

12. Therefore, many sides call for **further integration steps**. The report of the five presidents, for instance, proposes the swift launch of a common deposit insurance, and strengthened implementation of the Macroeconomic Imbalance Procedure (Juncker et al., 2015). The German Council of Economic Experts takes this as an opportunity to provide an **assessment of the rescue measures** in light of recent events. Against the backdrop of the existing rulebook, the Council also identifies **gaps in the Monetary Union architecture** and suggests potential means of closing them:

The banking union needs to be strengthened through further development of the resolution regime and establishment of integrated financial supervision. The privilege afforded to government bonds in banking regulation must be brought to an end. But above all, consistent application of fiscal and insolvency rules for states is needed to reduce debt levels and make the **no-bailout clause credible**. This would complete the Maastricht 2.0 framework proposed by the German Council of Economic Experts.

13. The Council thus expressly sets itself apart from proposals that hail the establishment of new fiscal authorities at EU level as the most important step for further European integration. The creation of a European unemployment insurance is also under discussion, along with broad coordination of the entire economic policy which determines the competitiveness of European national economies as part of an economic government. All of these proposals ignore the fact that this

would inherently require relinquishing key elements of national sovereignty at the same time. There is little willingness among member countries to do that.

14. In the German Council of Economic Experts' view, the conflict between the new Greek government and other member countries already demonstrates that the assumption of liability risks by European taxpayers, which was not democratically legitimised by previous relinquishment of national sovereignty, may be pose great **political risks**. This conflict has heavily affected the political and public discourse between the member countries. There seems to be a big difference for European cooperation between refusing to repay debt to anonymous financial markets and refusing to repay debt to taxpayers of other European countries.

Creating a European economic government would have the same potential for conflict. For this reason, the Monetary Union's institutional framework should be designed in such a way that public funds are used as little as possible to bail out countries or banks in crisis. Only then would it be possible to avoid such conflicts in future.

II. STATUS QUO

1. The current situation in Greece

15. A **new government** took office in January 2015 with the objective of renegotiating Greece's loan agreements with its creditors. After several unsuccessful rounds of negotiation, the second rescue programme was extended by four months to June. With agreement still not reached, the programme expired on 30 June. Greece defaulted on a repayment due to the International Monetary Fund (IMF), and the European Central Bank (ECB) saw itself forced to cap emergency liquidity assistance (ELA) for the banking system. This forced Greece's government to close the banks and introduce capital controls.

A political crisis in the Monetary Union

16. The escalation of the Greek crisis has not resulted in any major contagion effects in the financial system or real economy thus far. This was in line with the expectations of financial markets and the majority of the German Council of Economic Experts, although they feared political contagion effects (Feld et al., 2015). The drawn-out negotiations between European partners and the Greek government, which pursued a hard confrontational line and failed to meet the conditions of the ongoing aid package, did indeed lead to a **political crisis** in the euro area. The Greek government accepted both a dramatic downturn in its economy and a temporary freezing of the ECB's emergency liquidity assistance for the banking system. After successfully campaigning for a “no” vote to the offer by the creditor countries, the Syriza government seemed to many observers to be preparing the ground for Greece to exit the common currency.

17. Not until the 19 euro area heads of state and government met from 10 to 12 July of 2015 did the negotiations reach an agreement. We assume that, without considering the possibility of Greece temporarily and **voluntarily exiting** the euro area, there would have been little prospect of an agreement to work towards a third rescue programme with extensive conditions. The conditions imposed are essential given the scale of the financing commitments. The German Council of Economic Experts believes that it was prudent to raise the option of an exit from the euro area in this contentious dispute.

18. The new programme has at least offered a chance that the economic adjustment process for the Greek economy can be successfully completed within the Monetary Union. However, this programme will only be successful if it is implemented consistently. At the same time, the Monetary Union should intelligently develop its regulatory framework in order to prevent a similar **escalation of the political negotiation process in future**.

Negotiations on a third rescue programme

19. The euro-area heads of state and government have made **new negotiations on a third bailout package** conditional on the Greek parliament passing specific resolutions (Eurogroup, 2015a). As a first step immediate implementation of pension and VAT reform, strengthening the independence of Greece's national statistics office and appointing a fiscal council were demanded. The Greek parliament passed these measures on 16 July of 2015 (Eurogroup, 2015b). Subsequently a bridging loan was granted worth € 7 billion, enabling Greece to pay its instalment to the IMF overdue since June. A reform of the justice system and implementation of the Bank Recovery and Resolution Directive (BRRD) were introduced on 22 July.

The Greek government must also formally commit to prompt **reforms** of the product, energy, labour and financial markets in line with applicable EU and OECD standards, and to modernisation of public administration. A further requirement is for an independent trust fund to be set up for privatisations under the supervision of international institutions. Building a functioning market economy and encouraging foreign investors to enter the Greek market through privatisations is likely to boost competition and, ultimately, future growth.

20. Subject to these conditions, the creditors offer the prospect of **financing** totalling more than €80 billion over three years. This includes between €10 billion and €25 billion to recapitalise the banking system. A bridging loan of approximately €12 billion will enable Greece to redeem bonds held by the ECB. The plan also envisages financing from the IMF and capital market issues. However, it rules out a further debt haircut. Greece has also been promised funding from the European Commission to carry out up to €35 billion of investments.

Success factors for Greece

21. The key to a successful new programme is greater **willingness to reform (ownership)** on the part of Greek policymakers and the public at large. The

creditors should therefore aim to gain support for the programme's conditions not only from the Greek government, but from opposition parties too. Improved flexibility of rigid economic structures will require structural reforms. It therefore makes sense to draw upon external technical support, such as from the IMF, OECD, World Bank or public administrations from other countries. The policy of the current government to date, of suspending even those reforms already agreed, do not justify advance payment by the creditors. The individual tranches should therefore only be paid once Greece fulfils the programme's conditions (prior actions).

22. **Stabilising the banking system** is essential to restoring trust and growth. This means disclosing existing losses in bank balance sheets and recapitalising banks. Firstly, the owners must fully participate in covering losses. The holders of bank bonds and uninsured depositors must also be involved. As small depositors need protection and the remaining uninsured deposits are likely to be low in value, the scope for loss participation by depositors is limited. In the absence of Greek government funds, aid from creditor countries to stabilise the banks is essential.

The Greek government should not be permitted to exercise the **owners' rights of control**. The senior management should be replaced, with European or international institutions taking responsibility for monitoring and independent specialists for management. The European Investment Bank (EIB) and European Bank for Reconstruction and Development (EBRD) are already regarded as candidates for these roles (Gros and De Groen, 2015). Another option would be to sell the recapitalised Greek banks to foreign banks. Independence from local networks must be ensured to prevent conflicts of interest that could otherwise derail the success of the process. Only when trust has been restored can the capital controls be eased.

2. The stability of the Monetary Union

23. The European Economic and Monetary Union is intended to promote economic stability, growth and integration of the member countries. However, in order to reap the economic benefits of more deeply integrated goods and financial markets that promote competition through low transaction costs free from exchange rate risks, member countries must give up their independent monetary policy. They thereby forgo an important economic **adjustment mechanism** that was repeatedly relied upon in the decades prior to the introduction of the euro. Since, member countries suffering an economic downturn are no longer able to devalue their currency vis-a-visother countries. This eliminates one way to gain price competitiveness, and limits the option of reducing the country's debt burden by means of unexpected inflation.

Therefore, countries are left with the alternative of **internal devaluation**, i.e. adjusting wages and prices to restore price competitiveness and debt sustainability. The more rigid a country's goods and factor markets, the longer internal devaluation takes and thus the more difficult it proves to reduce unemployment.

24. The loss of the monetary policy tool implies that fiscal policy gains in importance for national economic policymaking. Yet, as in other areas of politics, there must be unity of liability and control. **Moral hazard** could emerge if joint liability for the fiscal policy of individual member countries is accepted at European level. Before the crisis, this risk was often dismissed as an abstract discussion and ignored by policymakers. However, it has since become evident how important this issue is in practice.

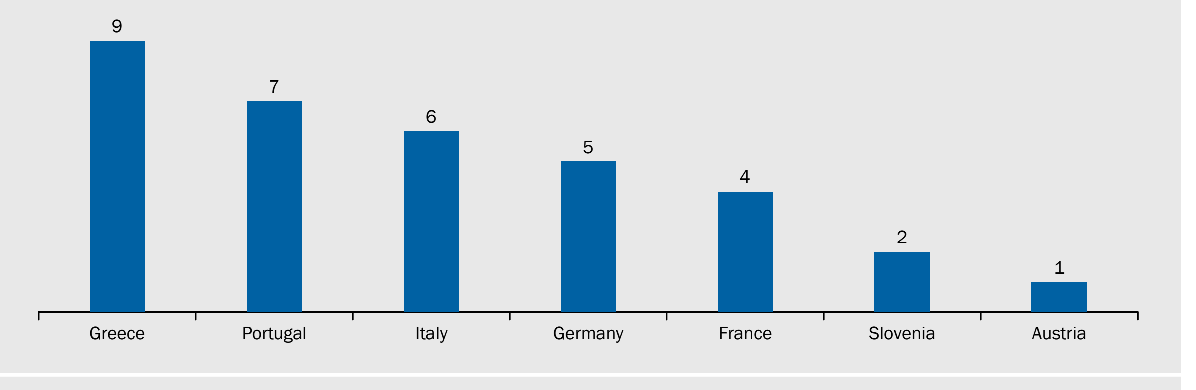
25. There are two basic options for a common currency area that hold the promise of long-term stability. In a **political union**, members cede sovereignty over their fiscal policy to a supranational body for the entire euro area. In return, the union assumes shared liability for collective government debt. Joint liability alone is insufficient; only an extensive transfer of sovereignty can effectively sustain this model of political union.

Alternatively, fiscal sovereignty and liability remain at **national level**. Instead of dealing with political partners when it comes to payment obligations, the individual member countries face anonymous financial markets. In this case, there must be a credible ban on transferring liability to other member countries, such as through a **no-bailout clause**. Only then can financial markets exercise their disciplining function by imposing higher risk premiums on government bonds, thereby demanding fiscal discipline by euro area members.

26. The euro members committed themselves to fiscal discipline in the **Maastricht Treaty**, and hence to the principle of fiscal sovereignty rather than political union. However, some countries subsequently violated the rules they had agreed in the Treaty, such as the Stability and Growth Pact (SGP) that had been intended to embed the no-bailout clause in fiscal policy. The planned sanction mechanisms were barely employed; there were 34 breaches of the 3% threshold for the general government deficit between 1999 and 2007 while none of these cases were escalated to the highest level of sanctions. ↘ FIGURE 1 The breaches of the pact by Germany and France in particular set precedents.

↘ FIGURE 1

Breaches of the 3 % threshold from 1999 to 2007[1]



1 – Number of breaches of the yearly budget deficit of 3 % as a percentage of nominal GDP according to the Maastricht treaty.

Source: Eurostat

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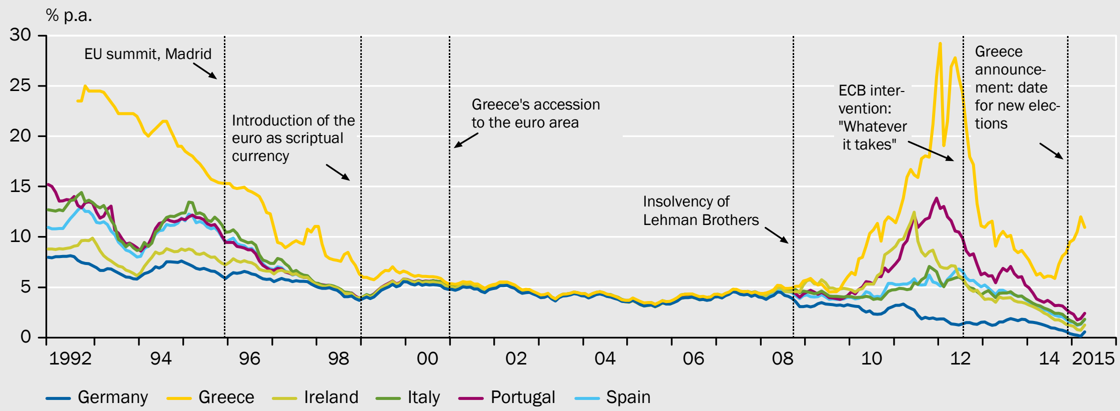
27. During this period, neither the SGP nor **financial markets** exercised sufficient discipline over financial policy. Despite their differences in macroeconomic and fiscal policy, the member countries were able to access financial markets at almost identical yields between 2001 and 2007. ↘ FIGURE 2 This is no surprise as member countries' government bonds were treated equally in both the ECB's refinancing operations and the capital requirements for banks.

↘ FIGURE 2
Long-term government bond yields[1]



1 – Government bonds with a residual maturity of around 10 years.
Source: Eurostat
SVR-15-213

28. This constellation provided no incentives for conservative financial policy. As a result, some member countries lacked sufficient fiscal space when the global financial and economic crisis hit the euro area. At the same time, there was no **crisis mechanism** capable of overcoming a systemic crisis. Such a crisis mechanism gradually evolved only after the crisis broke out, and only in parts. Only a forceful intervention by the ECB succeeded in calming financial markets in July 2012. By linking the outright monetary transactions (OMT) to the conditionality of the ESM programme, the ECB entered a grey area between monetary and fiscal policy (Annual Economic Report 2013 paragraph 253).

29. The principle of unity of liability and control was also violated in the **banking** sector. In the currency union, the member countries jointly bear the risks on the ECB balance sheet. If banking supervision and resolution are organised at national level, incentives are thereby created to shift risks in the domestic banking system to European level (Annual Economic Report 2013 paragraph 270). As result, there was little incentive to limit the build-up of excessive private debt by the banking system. In addition, there is a tendency to delay the restructuring of the domestic banking system in a crisis, which is reinforced by the fact that banks themselves are important creditors of member countries' governments. A further fundamental problem of the euro area was therefore the absence of a **common bank supervision** and a **credible common resolution mechanism.**

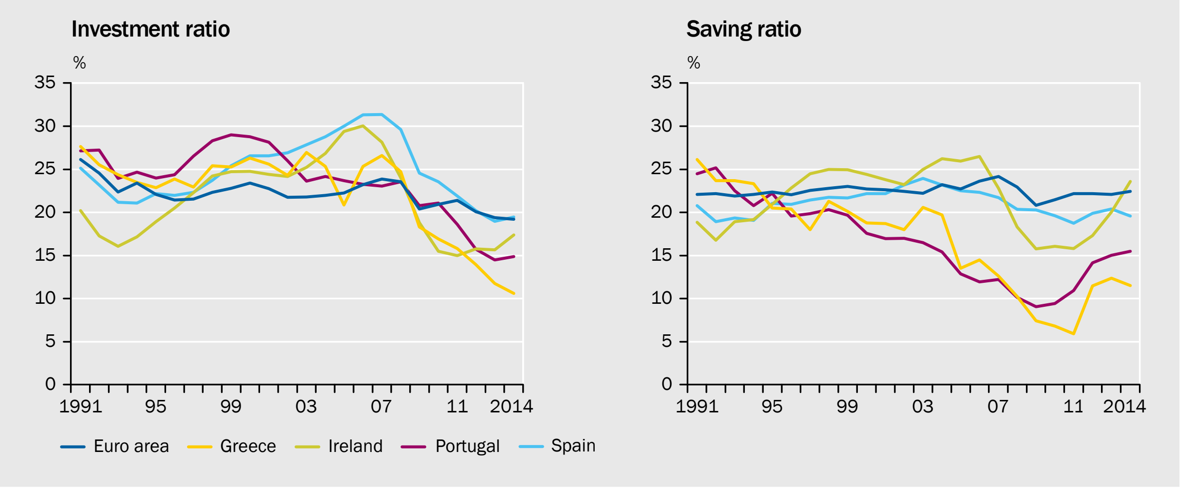
30. In summary, the European Monetary Union was created with conceptual and institutional weaknesses. **Completing the euro's architecture** and **achieving credibility** for its rules are key given the heterogeneity and rigidity of its member countries' economies.

III. REVIEW OF UNDESIRABLE DEVELOPMENTS IN THE CRISIS COUNTRIES

1. Credit-financed boom until 2007

31. The introduction of the euro and the **liberalisation of the European financial markets** was associated with a drastic reduction in country-specific risk premiums. This prompted a huge improvement in financing conditions for private households and public budgets in many euro member countries from the mid-1990s. This in turn led to **high capital flows** between member countries and corresponding changes in the macroeconomic saving and investment ratios (Jaumotte and Sodsriwiboon, 2010). Initially, this could be motivated by countries with lower per-capita income having higher growth potential. Therefore, it appeared logical to import foreign capital in addition to domestic savings to increase investment. However, notably in Greece and Portugal, saving ratios declined considerably between 2001 and 2007 while the investment ratio remained unchanged or weakened. ↘ FIGURE 3

↘ FIGURE 3
Investment and saving[1]



1 – Investment and saving in percent of nominal GDP.

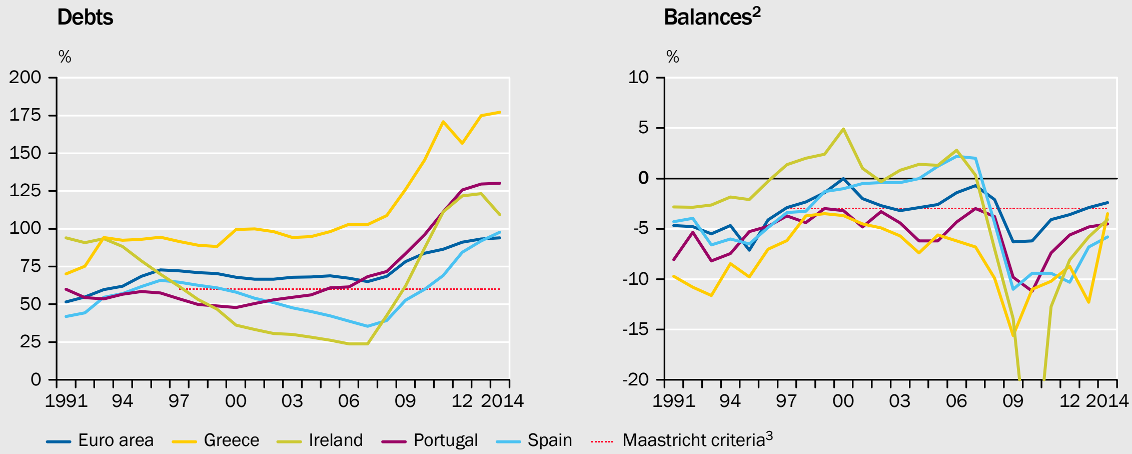
Source: IMF

SVR-15-237

32. The improved financing conditions reduced the interest burden on public budgets and could have served to reduce the stock of public debts over time. ↘ BOX 1 However, this relief was not utilised for debt reduction. ↘ FIGURE 4

FIGURE 4

General government debts and balances[1]



1 – In percent of nominal GDP. 2 – Until 1998 IMF data, then data from Eurostat to ESA 2010; for the euro area and Greece until 2010 by the ESA 95. 3 – Maximum debt 60 % and maximum budget balance –3 % under the Treaty of Maastricht.

Sources: Eurostat, IMF

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BOX 1

Scenarios of the effect of fiscal policy on the government debt ratio

The period prior to the introduction of the euro was marked by budget consolidation and a reduction in interest expenses. The introduction of the common currency was followed by an extensive erosion of budget discipline, combined with less positive economic conditions. This raises the question to what extent compliance with the SGP and the maintaining high primary balances (general government balances excluding interest) would have limited government debt.

The **change in the government debt ratio**, ΔVS_t,

$$\Delta VS_t = \left(i_t - \pi_t - g_t^{BIP,real}\right) VS_{t-1} - PS_t + other\ factors$$

is calculated using the average nominal interest, i_t, paid on the government debt in the previous period, VS_{t-1}, the primary balance for the current period in relation to gross domestic product, PS_t, and a residual which includes stock-flow adjustments. The latter are transactions that change the stock of debt but are not included in the public net borrowing statistics (Annual Economic Report 2013 paragraph 563). In addition to the factors mentioned, macroeconomic developments also affect the government debt ratio. For example, the ratio falls when there is a rise in real GDP, $g_t^{BIP,real}$, or in the price level, π_t, also in proportion to the government debt of the previous period, VS_{t-1}, all else equal.

Development of interest expense and primary balances

Around the turn of the millennium, yields on long-term euro area government bonds had aligned with the interest rates of German government bonds, resulting in **substantial cost savings** for public budgets. However, these cost savings were offset in many countries by a **weakening of the primary surplus** after their accession to the euro.

Greece, for example, incurred interest expenditures of over 10% of GDP until the mid-1990s. FIGURE 5, LEFT These had fallen to 7.2% by the year 2000, and to just 4.6% by 2007. Greece's average primary surplus was around 4% of GDP from 1998 to 2000, but fell following euro adoption until 2007 – despite positive economic conditions – to a deficit of 2%. This deficit then widened further to 10% during the euro-area crisis. The decline in interest expenses was thus **overcompensated** by a deterioration of the primary balance, resulting in an increase in the government debt ratio after 2003.

Scenarios

The effect of this decline in fiscal discipline on the government debt ratio can be illustrated by two scenarios. For simplicity's sake it is assumed that growth and interest are exogenous. The **first scenario** assumes that the countries had maintained their fiscal discipline, measured by the average primary balance of the three years prior to the introduction of the euro. After euro adoption, the primary balance is adjusted for each country to equal at least this average. The accumulated change in the government debt ratio is then determined on the basis of the adjusted primary balances. ↘ FIGURE 5, RIGHT The scenario shows that Greece and Portugal would have been in a significantly better fiscal position in 2007 and 2008. The difference between the debt ratio under this scenario and the actual debt ratio in Greece is more than 40 percentage points of GDP; for Portugal, the difference is 8 percentage points.

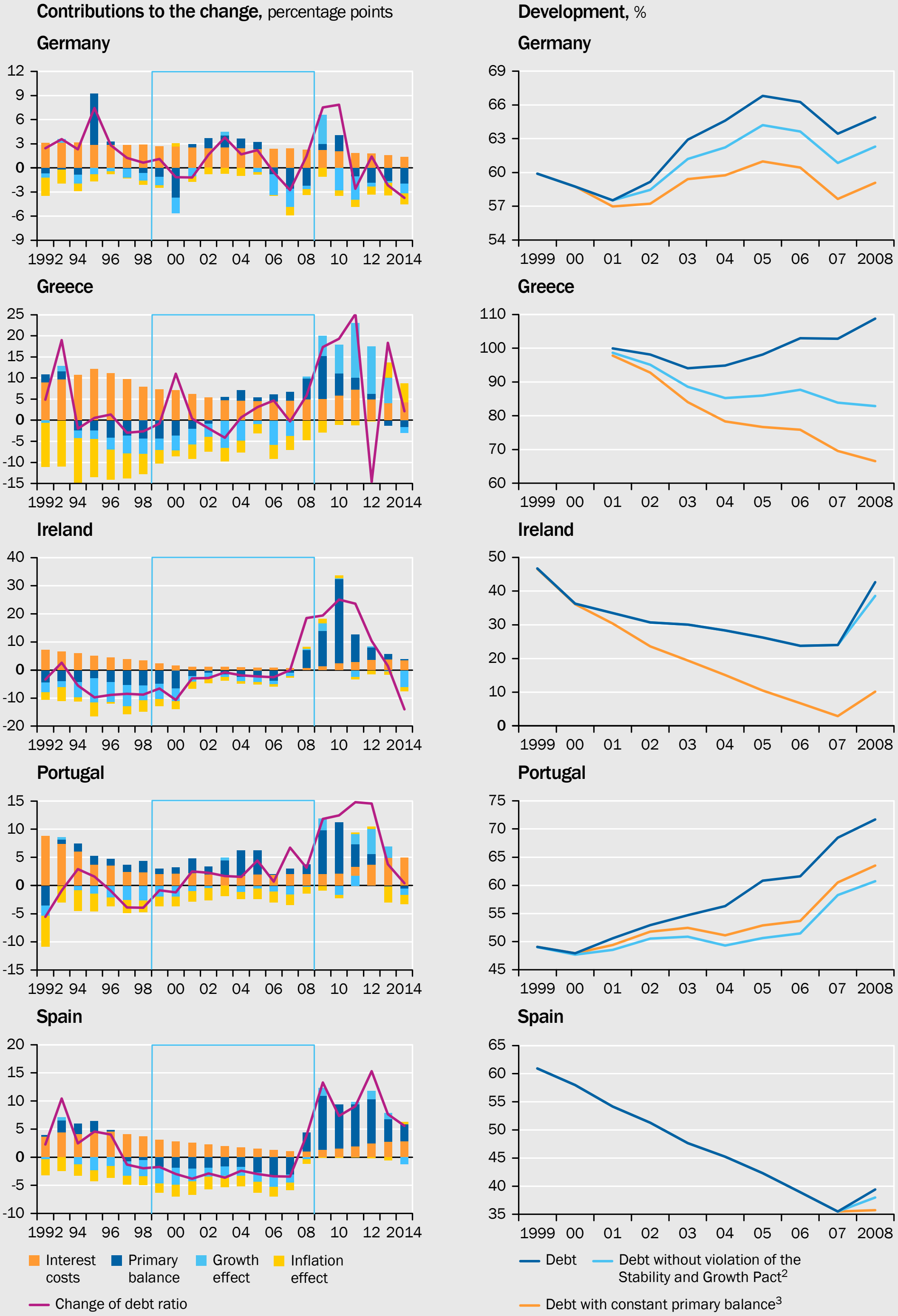
The **second scenario** analyses whether at least strict adherence to the original SGP would have helped to prevent the rise in government debt ratios before the crisis. Here we assume that the government deficit does not exceed 3% of GDP, i.e. the limit prescribed by the SGP, in order to determine the accumulated effect on the government debt ratio. The result shows that Greece's accumulated violations of the Stability and Growth Pact until 2008 still amounted to 26 percentage points relative to GDP. Germany's accumulated violations from 2002 to 2005 total just 2.5 percentage points in comparison. Strict adherence to the original SGP would have meant a stock of public debts of 83% and 61% of GDP respectively for Greece and Portugal in 2008, instead of the actual debt ratios of 109% and 72% of GDP.

This scenario illustrates that consistent compliance with the SGP would have created fiscal space and likely reduced the extent of the debt crisis. In contrast to Germany, the accumulated violations of the SGP by Greece and Portugal made a material difference to their debt ratios. These set Greece and Portugal also apart from Ireland and Spain, which achieved compliant government budgets before the crisis.

However, the quantitative results of the counterfactual simulations must be analysed with care, as they disregard the interaction between primary balances, interest rate developments and growth. The extent of this interaction can only be estimated using a comprehensive macroeconomic model.

↘ FIGURE 5

Contributions and scenarios to the development of debt ratios[1]
Data in percent of nominal GDP



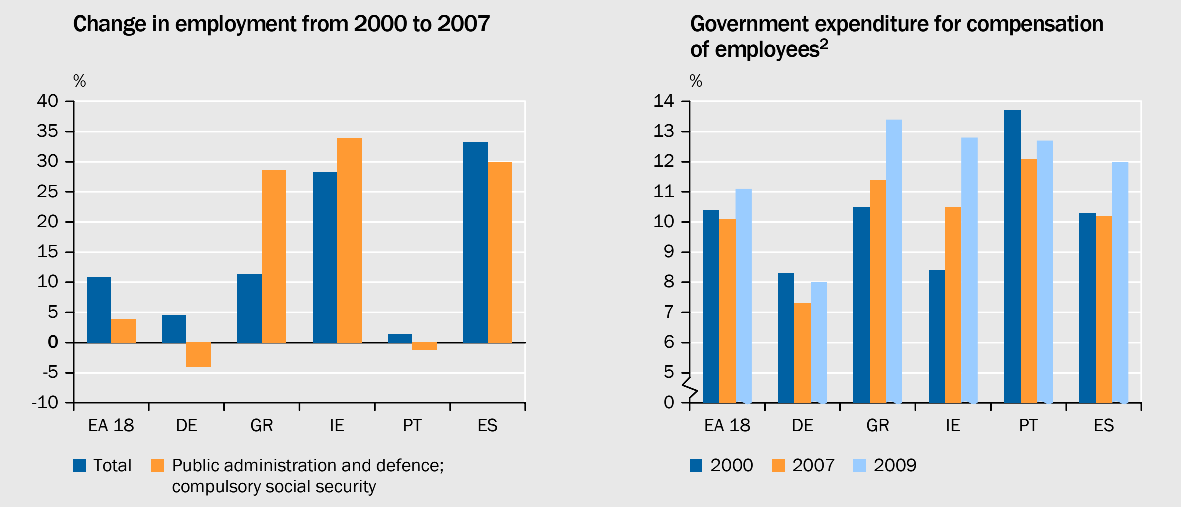
1 – Own calculations. 2 – Scenario: 3 % deficit threshold of the old Stability and Growth Pact is respected each year.
3 – Scenario: At least the average primary balance of the last 3 years prior to the introduction of the Euro is reached each year.

Sources: IMF, German Council of Economic Experts

SVR-15-239

33. Additional public expenditures were often used for **government final consumption expenditure** and not for capacity- and productivity-enhancing investment. The development of employment and wage in the public sector serves as illustration. ↘ FIGURE 6 For instance in Greece, public sector employment rose by more than 25% between 2000 and 2007. Government spending for staff doubled from around €14 billion to €28 billion. The increase in government spending exceeded inflation in many other areas, such as pensions (OECD, 2011a).

↘ FIGURE 6
Employment and compensation of employees[1]



1 – EA-18-Euro area (18 countries), DE-Germany, GR-Greece, IE-Ireland, PT-Portugal, ES-Spain. 2 – In percent of nominal GDP.

Source: Eurostat

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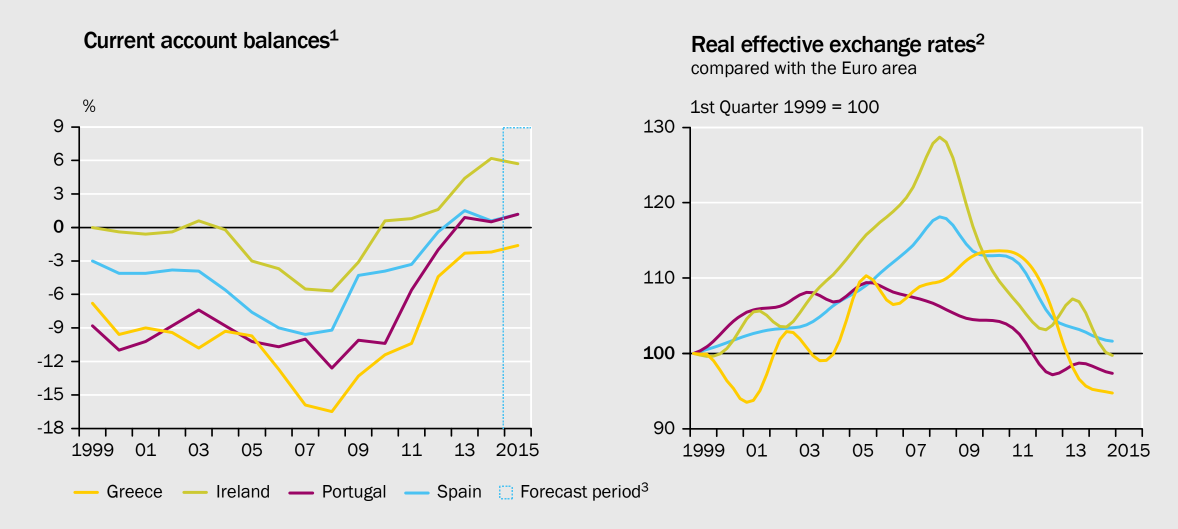
34. Unlike Greece and Portugal, Spain and Ireland **did not violate the SGP** prior to 2007. They actually reported public budget surpluses for several years and were able to reduce their stock of public debt. In these countries, macroeconomic vulnerabilities were built up mainly in the **private sector**. The improved financing conditions following the introduction of the euro also triggered significant credit growth, particularly in the household sector, which led to excessive booms in the real estate sectors of some countries (Annual Economic Report 2013 box 26). These booms benefited from a lack of regulation, insufficient supervision and loose monetary policy.

35. Despite the differing causes of the sharp rise in the economies' overall indebtedness, these had overall similar effects on macroeconomic developments. All observed countries suffered a **considerable loss in price competitiveness** during the debt-financed booms, due to major wage increases and high inflation rates. This resulted in a competitive disadvantage for domestic export companies, that in turn led to a **loss of trade share**.

The loss of price competitiveness combined with the debt-financed increase in domestic demand and the associated imports resulted in high **current account deficits**. ↘ FIGURE 7 For instance, Greece and Portugal reported average current account deficits of around 10% of GDP between 2000 and 2007.

↘ FIGURE 7

Current account balances and real effective exchange rates



1 – In percent of nominal GDP. 2 – On unit labour costs basis. 3 – Forecast of the European Commission.

Source: European Commission

SVR-15-228

2. The crisis from 2008

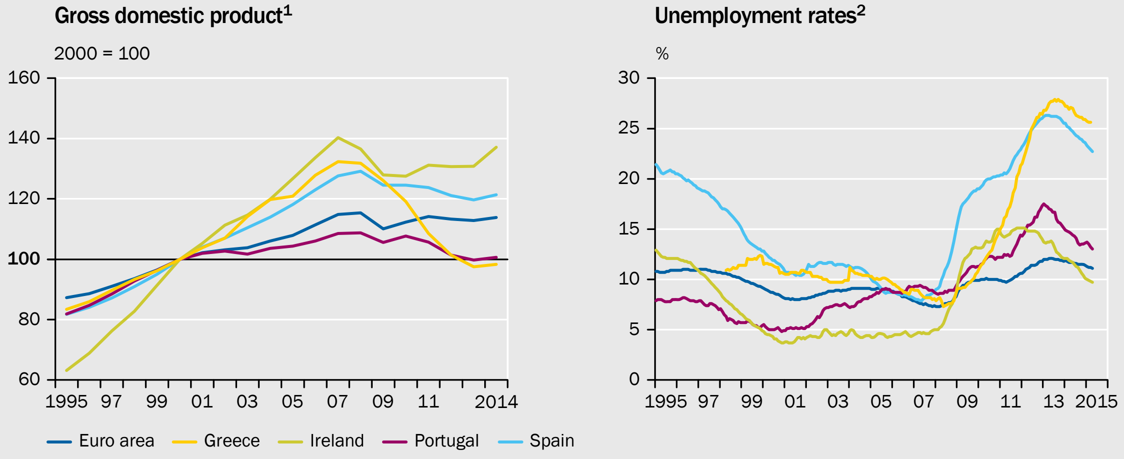
36. The economic upturns prior to 2008 in the countries later undergoing adjustment programmes relied on strong capital inflows from abroad. The capital providers believed that the positive economic development would continue, or that the no-bailout rule would be suspended in the event of crisis, and therefore **did not demand appropriate risk premiums**. Then, starting in 2007, the world economy suffered a major shock as a result of the global financial crisis.

37. At the beginning, the global crisis triggered a **reassessment** of the expected profitability of past investments by market players, primarily in the real estate sector. Another factor contributing to the crisis was that uncertainty with regard to losses casted doubts over the stability of the financial system. The resulting slump in demand also spread to other national economies via global trade. ↘ FIGURE 8, LEFT

The unfolding of a systemic financial crisis throughout Europe caused an increasing **mistrust among market players**. This was followed by a sharp rise in risk premiums. Debtors applying for loans became subject to increased scrutiny. Germany also saw a tightening of lending standards. Increasingly, the structural problems of the later programme countries became a focus of the financial markets.

↘ FIGURE 8

Indicators for economic development



1 – Real values, seasonally and calendar-adjusted. 2 – In relation to the labour force.

Source: Eurostat

SVR-15-193

38. Once the crisis had broken out, market players increasingly realised that Greece, Ireland, Portugal and Spain **greatly lost competitiveness**. In Portugal, and Greece in particular, the unfavourable fiscal position led to a sovereign debt crisis, while Ireland and Spain – with low public debt – came under pressure primarily due to the **sovereign-bank nexus** given public budgets had to assume the burden of non-performing loans in order to avoid a systemic financial crisis across Europe. The banking systems of all programme countries, and other countries too, were supported by vast amounts of public funds. In Ireland, for instance, the **costs of the 2009-2011 bank rescue** alone caused an increase in the government debt ratio of some 40 percentage points (Laeven and Valencia, 2012).

39. The doubt on the financial markets regarding the solvency of the crisis countries triggered a sharp rise in risk premiums for government bonds. This was followed by a vicious circle of rising debts, dwindling trust and increasing risk premiums. Greece was the first member country forced to make use of **assistance loans** from the IMF and the European partners in May 2010. With the EFSF and EFSM, a system of European rescue funds was created. In part it was hoped that the existence of a rescue fund would generate sufficient trust and prevent a worsening of the crisis in other countries. However, this was not the case. Subsequently, Ireland and Portugal were also forced to apply for assistance loans combined with a macroeconomic adjustment programme in November 2010 and April 2011 respectively. Spain followed suit in July 2012 with an assistance loan to support its banking system.

40. The rescue package was based on the “loans for reforms” rationale, i.e. rescue loans granted in exchange for the implementation of **extensive reforms**. These included fiscal consolidation, measures to regain price competitiveness, deregulation of goods and factor markets, and improvements of the institutional framework. Implementing these measures represented a major **social and economic challenge** for the governments of all programme countries. All pro-

gramme countries saw a massive decline in employment. Labour mobility was only partly able to mitigate the rise in unemployment. ↘ FIGURE 8, RIGHT

41. The agreed **reforms** were largely **successfully implemented** in Ireland and Portugal. The IMF's evaluation of the Irish adjustment programme shows that Ireland achieved the agreed programme objectives almost completely and on schedule (IMF, 2015) Portugal was also successful in implementing the agreed measures in its macroeconomic adjustment programme (European Commission, 2014). However, the Portuguese economy is not as dynamic as that of Ireland.

42. Ireland, Portugal and Spain have now exited their rescue programmes, thanks to successful consolidation and reforms, as well as the ECB's extensive monetary easing. The economies of these countries are **recovering**: There is a marked decline in unemployment in Spain and Portugal, and gross value added has been on the rise since last year. In **Ireland,** a notable rebound started earlier and is still ongoing, partly owed to its comparatively flexible labour market and the recovery of key trade partners, in particular the US and UK.

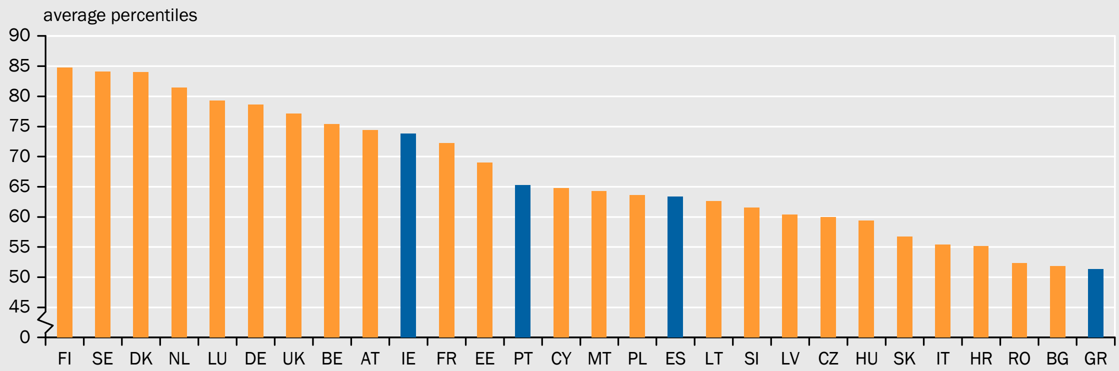
43. The situation is rather different in **Greece**, where economic output was most heavily affected by the crisis. Real GDP has fallen by around 26% since 2007, and in 2014 was just below the level of 2000. Macroeconomic development in Greece is faltering, although there was slight economic growth in 2014. The likely reason for this subdued recovery is that the majority of Greece’s capital stock was **not productive** already at the time when the crisis broke out (Boysen-Hogrefe et al., 2015)

44. Greece has implemented a large number of both fiscal and structural reforms since 2010. Its **fiscal adjustment** was much more extensive than in Ireland, Portugal or Spain. However, in contrast to the fiscal adjustment, Greece is notably behind schedule in **implementing structural reforms**. Many measures that are vital for the long-term improvement of the country's growth prospects have yet to be implemented. Greece thus frequently failed to meet the agreed objectives of the reform programmes (IMF, 2013, 2014a). An OECD study indicates that the public administration in Greece is partly at blame given its lacking ability to implement complex reforms (OECD, 2011b).

45. The structural problems – particularly those of the Greek economy – are evident from non-price competitiveness indicators. **Non-price competitiveness** covers a range of indicators (Annual Economic Report 2014 paragraph 144 ff.) including factors such as the effectiveness of government institutions, the quality of the infrastructure and business conditions. While the available indicators are subject to methodical issues (Annual Economic Report 2004 box 28), overall they provide a wide range of relevant information on the condition of the institutional environment (ECB, 2014a). Studies suggest that non-price competitiveness factors are indeed highly important for the development of euro-area countries (Estrada et al., 2013).

↘ FIGURE 9

Non-price competitiveness in the European Union[1]



1 – FI-Finland, SE-Sweden, DK-Denmark, NL-Netherlands, LU-Luxembourg, DE-Germany, UK-United Kingdom, BE-Belgium, AT-Austria, IE-Ireland, FR-France, EE-Estonia, PT-Portugal, CY-Cyprus, MT-Malta, PL-Poland, ES-Spain, LT-Lithuania, SI-Slovenia, LV-Latvia, CZ-Czech Republic, HU-Hungary, SK-Slovakia, IT-Italy, HR-Croatia, RO-Romania, BG-Bulgaria, GR-Greece. Calculations based on data of the World Bank Institute (Worldwide Governance Indicators 2013), World Economic Forum (The Global Competitiveness Index 2014-2015) and Transparency International (Corruption Perceptions Index 2013). 100 is the highest possible rating score.

Source: ECB

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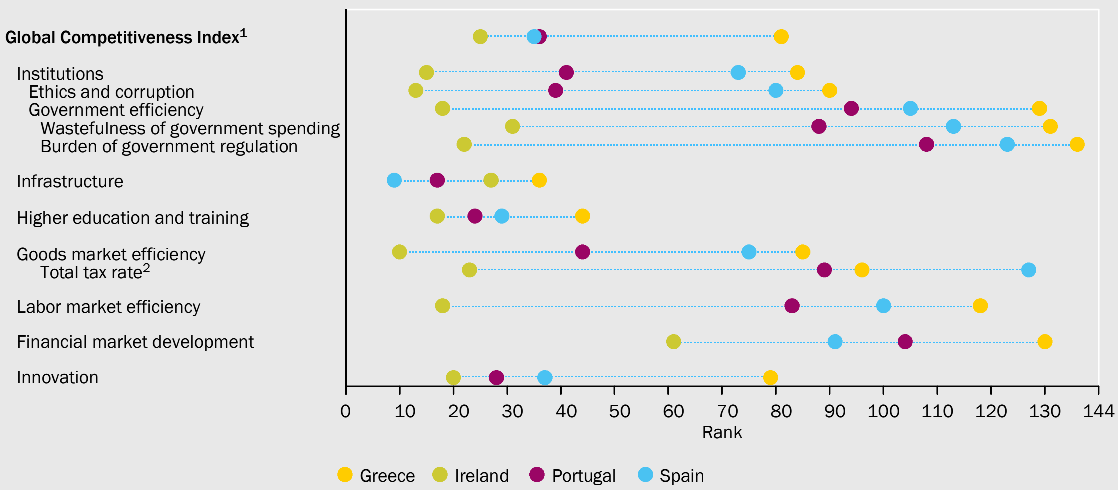
46. **Greece's non-price competitiveness** is shown as remarkably **weak** by practically all available indicators. For example, the aggregated figures from three widely recognised indicators currently show Greece to rank last in terms of non-price competitiveness within the European Union. ↘ FIGURE 9 Moreover, Greece is shown to have notable deficits in those subcategories of the Global Competitiveness Indicator which relate to the efficiency of institutions and of the goods and labour markets, and financial market development. ↘ FIGURE 10 However, particularly these categories are of special relevance for the success of the macroeconomic adjustment programmes.

↘ FIGURE 10

Selected indicators for non-price competitiveness (2014)



1 – Global Competitiveness Index (GCI): Rank of selected indicators of the GCI to the perceived economic competitiveness in an international comparison (144 countries). 2 – % profits.

Quelle: World Economic Forum

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47. The **structural reforms** agreed are far from sufficient to ease the problems of the Greek economy. Despite the intense reform activity, Greece continues to rank last within the European Union in terms of non-price competitiveness. On the one hand this is due to the exceptionally low initial level of competitiveness at the outset of the crisis. On the other hand, this results from not having implemented every reform agreed consistently. This is likely a key reason for Greece's significantly weaker macroeconomic development compared to the other programme countries. It is therefore vital that Greece urgently step up its reform efforts regarding the public administration as well as its financial, labour and goods markets.

IV. EURO CRISIS RESCUE POLICIES

1. Looking at the big picture

48. The rescue policy pursued by the European partners and therefore also by the German Federal Government, which played a key role in shaping this strategy, is often considered to have been a **failure**. The main criticism levelled against the strategy is that the rescue measures did not result in any significant improvement in Greece's macroeconomic situation compared to the outset of the crisis. Moreover, critics point to considerable risks for the German federal budget associated with the rescue packages.

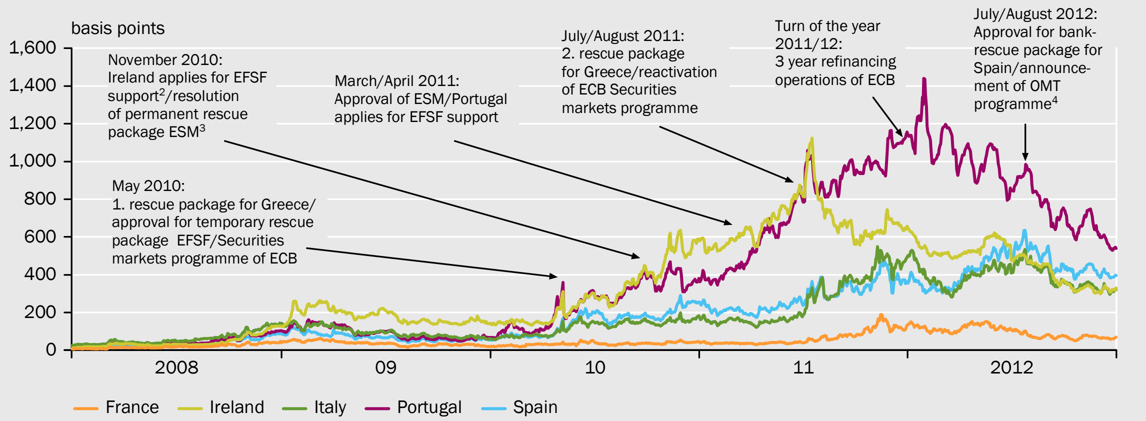
49. This evaluation, however, fails to consider the positive aspects of the **big picture**. As any review of the undesirable developments that led up to the crisis clearly shows, painful macroeconomic adjustments were inevitable after the crisis had broken out. Even in the absence of a coordinated rescue policy by the European partners, the financial markets would have forced the crisis countries to endure a prolonged period of austerity. The only thing that could have spared Greece this tough adjustment would have been massive long-term transfers from other member countries (some of which have lower per capita incomes). All of the euro-area countries felt that the rescue strategy chosen, namely mutual support in the form of emergency lending combined with moves to **strengthen rule-based policies**, was the right approach on the whole.

50. First of all, there was a risk that contagion effects would trigger a **systemic financial crisis**, as the risk premiums on government bonds and the liquidity outflows in several euro-area member states show. ↘ FIGURE 11 This prompted the European governments, together with the ECB, to take **measures** to calm the financial markets in May 2010. The blunt enforcement of the no-bailout rule appeared too risky an approach to Greece back in 2010, as it would have required debt restructuring and would have jeopardised market access for other euro member countries. As a result, the governments of the member countries opted for the first rescue programme for Greece and the establishment of firewalls in form of the EFSM and EFSF (Annual Economic Report 2010 Box 6). Further-

more, the ECB launched the Securities Markets Programme (SMP) for the purchase of government bonds of crisis countries.

↘ FIGURE 11

Interest rate spreads on government bonds compared to Gemany[1]



1 – Differences between the yield on 10-year government bonds of each country relative to German government bonds. 2 – European Financial Stability Facility. 3 – European Stability Mechanism. 4 – Outright Monetary Transactions.

Source: Thomson Financial Datastream

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At that time, a member country's default would have put a massive strain on the European financial system. Instead of the rescue packages for the countries in question, **more substantial funds would have been required to recapitalise the national banks** of other countries, including Germany. As a result of the global financial crisis, German banks had already been recapitalised by the state to the tune of €54.2 billion by the end of May 2010. In addition, guarantees totalling €185.8 billion were granted and risks worth €56.3 billion assumed (Stolz and Wedow, 2010). Back then, German and other European banks still had substantial foreign claims against the crisis countries. ↘ TABLE 1 At that time, the risk of a "**credit crunch**" allegedly caused by undercapitalised banks was already becoming a hot topic in German economic circles (Sinn, 2009; Annual Economic Report 2009 paragraph 86 ff.; Annual Economic Report 2009 Box 2).

↘ TABLE 1

Consolidated foreign claims of banks of selected euro area member states against crisis countries
End of March 2010

Crisis countries	Total	including:						
		Germany	France	Netherlands	United Kingdom	United States	Germany	France
	bln US-Dollar						share in %	
Greece	202,6	44,2	71,1	11,3	11,8	13,6	21,8	35,1
Ireland	627,6	174,0	50,3	25,9	164,0	60,6	27,7	8,0
Portugal	243,6	44,5	42,1	12,2	25,0	5,2	18,3	17,3
Spain	857,0	213,1	199,8	99,5	110,2	62,2	24,9	23,3
Total	1 930,8	475,8	363,3	149,0	311,0	141,7	24,6	18,8

1 – Countries which are reporting to the Bank for International Settlements (BIS).

Source: BIS

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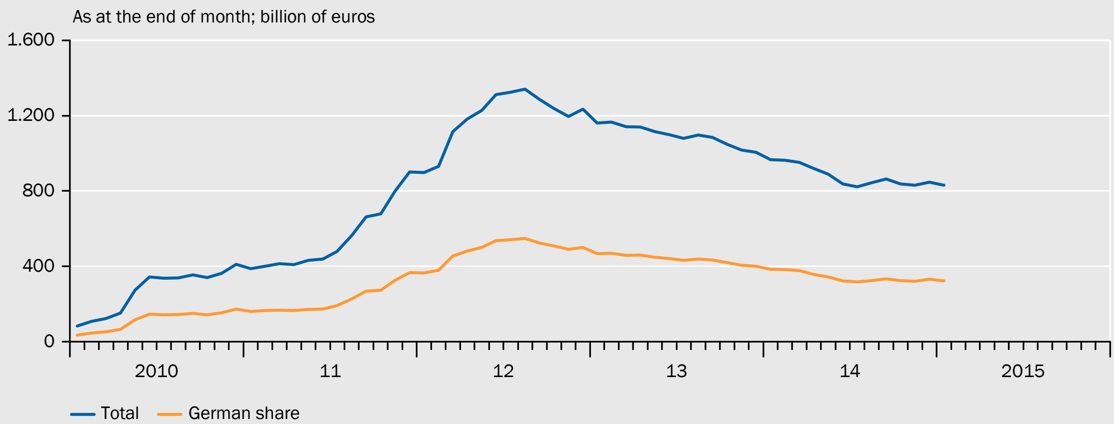
51. Secondly, it is important to bear in mind that, in the context of the SGP, the Monetary Union's institutions tolerated undesirable fiscal developments, especially in Greece, without imposing sanctions in the run up to the crisis. In other words, the **European institutions contributed to the vulnerability**, and hence had to take special responsibility for combating the crisis. This does not, under any circumstances, relieve the Greek governments of their responsibility for fiscal policy. The other countries, however, should have intervened via the SGP while the debt was being accumulated. At the same time, financial markets also failed to discipline national fiscal policies sufficiently.

As a result, the costs associated with the rescue can be seen as the **consequence of mistakes** made in translating the currency union into practice, which in many cases happened with total disregard for prior agreements. This negligent behaviour hugely underestimated the impact of misguided national fiscal policy, of a European system of fiscal surveillance that failed to act adequately, and of the lack of common bank supervision. This suggests that similar crises could be avoided in the future by making agreements more stringent and being more consistent in requiring countries to stick to the rules.

52. Thirdly, the economic recovery in Ireland, Portugal and Spain shows that Europe's rescue policy can work. These countries have managed to **achieve a turnaround**, even if it will take some time to bear further fruit. The political strategy of only granting financial support in return for structural reforms has helped these countries to regain market access and ensure their governments' ability to act. The risk exposures assumed for these countries by the European governments, the ECB and the IMF have already fallen considerably since the crisis reached its peak in mid-2012. ↘ FIGURE 12

↘ FIGURE 12
Liability risks of disbursed assistance[1]



1 – Outstanding loans from euro-area creditors from aid programs for Greece, Ireland, Portugal, Spain and Cyprus; ECB government bond purchases from SMP and Target liabilities and below-average banknote issue of Greece, Ireland, Italy, Portugal, Spain and Cyprus.
Note: The Target balances for the last months represented are not yet available for Ireland, Portugal and Cyprus. For these countries the last value published (for the second or third to last month) was used to update the time series.

Source: ifo

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2. Rescue policy broadly appropriate

53. Particularly in the context of the Greek crisis, one criticism often raised is that the **austerity policy**, i.e. a call for deficits to be slashed as soon as possible, has actually hindered growth and crisis resolution instead of promoting them (Krugman, 2015; Stiglitz, 2015; Summers, 2012). The decline in economic activity in crisis countries is largely attributed to fiscal austerity imposed by the lenders. These critics argue that the alternative for these countries would have been "grow out" of their debt problems with the help of demand boosting stimulus packages. The Council cannot concur with this view for several reasons.

54. Rescue loans generally facilitate a slower fiscal adjustment as opposed to the **instant consolidation** that would be necessary absent rescue loans (Blanchard, 2015). Since 2010, Greece lost market access and would have been forced to balance its budget right away without the financial support of its European partners. The rescue programmes made it possible to achieve the necessary adjustment in a more structured fashion and, as a result, with fewer social repercussions. The rescue programmes thus helped to prevent a more fierce austerity policy. So the only contentious aspect of the rescue policy is whether it would have been possible to spread this process out over an even longer period.

55. **Stretching the consolidation efforts out over time**, however, inevitably increases the credit volume of the rescue programmes, which, in turn, is subject to the political and economic restrictions of the lenders' governments and parliaments. When weighing the costs of a rescue programme against the consolidation requirements for the respective crisis country, it is important to remember the large-scale opposition to the rescue packages that had to be overcome in those member countries financing the rescue efforts.

Moreover, major incentive problems arise during negotiations regarding the willingness of the crisis countries to implement far-reaching reforms. As the lenders' exposure increases with the volume of loans granted, so too do the political costs associated with a write-off. This gives the debtor nation more bargaining power and generates the problematic incentive to "throw good money after bad" (**Escalation of Commitment**; Staw, 1981).

56. Admittedly, **growing out** of their debt is possible for countries in theory. This could actually be achieved fairly quickly if primary surpluses were to be generated and, at the same time, nominal economic growth were to exceed the effective interest rate on government debt. The effective interest rate on Greek government debt is, in fact, extremely low compared with other euro-area countries. What is more, the rescue programmes help to dampen any demand slump as private and state consumption continued to exceed disposable incomes. However, demand-stimulating measures alone are unlikely to generate higher economic growth due to structural weaknesses.

When the crisis hit, all crisis countries were facing major problems in regard to their price and non-price **competitiveness**. This is illustrated by the inflation and wage development in these countries. The correction of excessive prices is reflected in a drop in nominal GDP in the national accounts. Yet, more crisis lending to boost demand would have done little to overcome these countries' structural problems (Blanchard, 2015).

57. Empirical results show that macroeconomic adjustments in the aftermath of debt or currency crises are typically associated with **significant decline in growth**. Although the initial output losses within a monetary union are not as pronounced as in a system of flexible interest rates, the adjustment processes is much drawn out. Nevertheless, the euro-area crisis countries have made significant progress (Annual Economic Report 2013 paragraph 84 ff.; Annual Economic Report 2014 paragraph 216 ff.).

58. All in all, the **crisis strategy** of providing public funds in return for reforms and fiscal consolidation efforts is **proving quite successful**. From the perspective of the democratically elected parliaments of the lenders, there is no option other than to tie the provision of the loans to certain conditions and to review whether these commitments had been fulfilled.

Regarding the rescue policy for **Greece**, however, the question arises whether the reform efforts made to date have focused enough on establishing a functioning and efficient public administration. This would have triggered a considerable improvement of non-price competitiveness, which in turn would have created incentives for economic activity and investment. Achieving budget targets just by untargeted spending cuts and early retirement of civil servants triggers a temporary drop in demand and economic output. Also, tax hikes are detrimental to growth in the long term (Annual Economic Report 2013 paragraph 209 ff.; Wolters, 2013).

3. The role of the ECB in crisis resolution

Financial market interventions

59. At the peak of the euro crisis to date, in summer of 2012, the **ECB** played a key role in **calming the financial markets.** By launching the Securities Markets Programme and introducing Outright Monetary Transactions (OMT), however, the ECB ventured into a grey area between monetary and fiscal policy. By buying up government bonds it risks to increase the joint liability of the euro-area countries without democratic legitimation. This is why the German Council of Economic Experts is in favour of using fiscal tools to tackle debt overhang of individual countries.

60. In order to prevent the euro area crisis from escalating to a point that would threaten the very existence of the Monetary Union, the ECB launched **OMT** in the summer of 2012 for the purchase of short-term government bonds issued by programme countries (Annual Economic Report 2012 paragraph 133, box 8). The OMT programme is unlimited and, in the context of the wording used by ECB President Draghi, was interpreted as a move to ensure the cohesion of the Monetary Union "whatever it takes". This may result in misdirected incentives

for economic policy. Although the ECB has tied the OMT transactions to the conditions imposed by the crisis programmes, the promise of market intervention by the ECB could indirectly create a political incentive for a less stringent interpretation of the programme conditions (the “Draghi put”), such as tolerating higher budget deficits (Annual Economic Report 2012 paragraph 134).

61. This fuels concern that the SMP and OMT programmes could restrict the **political independence** of the central bank and that the resulting conflict of interest could pose a risk to price and financial stability. At the same time, it will depend on the **incentives created by OMT** whether the three main challenges – consolidation of public budgets, reform of the banking sector and the strengthening of potential growth – are being tackled (Annual Economic Report 2013 paragraph 253). After all, addressing these challenges are the only way to lay the crisis to rest.

ELA loans

62. Another important aspect relates to the ECB's role in providing bank liquidity. Solvent commercial banks facing a temporary liquidity shortage may, in exceptional cases, be eligible for **Emergency Liquidity Assistance** (ELA) from their national central banks (ECB, 2014b). This system allows the central banks to accept collateral that deviates from the standards applied to normal refinancing operations. This decision is at the discretion of the national central bank that bears the risks associated with the measure, and can only be rejected by a two-thirds majority of the ECB's Governing Council (Annual Economic Report 2012 paragraph 141). This means that it is largely the national central bank and not the ECB that ends up playing the role of **lender of last resort**.

63. The ECB blocked access to the ECB refinancing window for Greek banks back in February prior to the expiry of the adjustment programme for Greece (ECB, 2015). Since then, ELA loans have been the source for central bank liquidity, subject to limits discussed in regular meetings of the ECB Governing Council. At the very latest by the end of the second assistance programme at 30 June, the continuation of ELA in Greece raises **serious concerns regarding monetary financing** (Weidmann, 2015). The German Council of Economic Experts has already warned in the past that some of the measures involved in granting emergency assistance could be viewed as a form of monetary state financing (Annual Economic Report 2013 paragraph 207).

64. In summary, the rescue policy can certainly be considered appropriate when viewed in the context of the particular circumstances. Often compromises were incurred as the crisis mechanism evolved. Before the ECB launched the OMT programme in July 2012, crisis management was aimed at **allowing the necessary time for reforms without alleviating reform pressure.** The fact that all of the crisis countries with the exception of Greece have achieved an economic turnaround is testimony to the effectiveness of this approach.

V. DEVELOPING THE FRAMEWORK FURTHER

65. The largely positive assessment of the rescue policy must not disguise the considerable **need to overhaul the euro area's institutional framework**. Although many reforms of recent years have already set the right course, the **regulatory framework needs prudent further development** and there must be **consistent compliance with common rules**. There is particular room for improvement in the banking union, whose resolution mechanism needs to be completed and for which an independent, integrated financial supervision must be created. Government bonds should be subject to the same regulatory treatment as other bank assets. A simplification and more stringent supervision of European fiscal rules is essential to ensure that the legacy of high government debt is reduced. Simultaneously, there is need for effective State insolvency proceedings to increase the credibility of the no bail-out clause.

1. A stable institutional framework

66. In the future, the existence of the Monetary Union should not be endangered by economic crises in individual member countries. There must be no more endurance tests such as the recent wrangling over a viable plan to support Greece. Thus, the Monetary Union's institutional framework must be further developed. All conceivable reform proposals primarily differ in the extent to which national-level fiscal and economic policy **competencies and liability are shifted** to European level. Ultimately, the only convincing proposals are those ensuring that control over fiscal and economic policy action is accompanied by liability for the consequences of such action. Any setting, in which these two aspects diverge, bears potential wars of attrition and can result in serious political tension.

67. In terms of the financial market framework, the establishment of the European **Banking Union** during the last few years created the counterpart to the common monetary and currency policy. Even if the banking union needs to be strengthened by further reforms as outlined below, the extensive transfer of supervisory, restructuring and resolution authority to European level has so far ensured the unity of liability and control.

68. Concerning **fiscal and economic policy**, two basic constellations can be derived from the principle of unity of liability and control:

- the transfer of fiscal and economic sovereignty to **European level** and simultaneously the assumption of comprehensive joint liability by the European partners. This approach requires the establishment of an effective central decision-making authority at the European level endowed with the power to enforce tax increases, spending cuts and structural reforms in a country if necessary (problem of intervention rights).
- the continuance of **national sovereignty** over fiscal and economic policy with exclusion of any joint liability for government debt. This means the no-

bailout clause applies. Appropriate protection needs to be established to avoid that liquidity or solvency crises of individual member countries spread to the rest of the euro area, which may cause the no-bailout clause to be disregarded (problem of credibility).

69. For the **practical implementation** of these basic ideas the question raises of whether the accompanying problems – insufficient rights of intervention and insufficient credibility – can be effectively addressed. The German Council of Economic Experts believes that this is only possible for the second option of continuance of national sovereignty over fiscal and economic policy, even though the credibility of the no-bailout clause is not easy to establish.

It considers the success of a democratically legitimised transfer of fiscal and economic sovereignty to the European level, on the other hand, as unlikely. The euro-area member countries are overwhelmingly **unwilling to give up national budgetary autonomy** (Annual Economic Report 2012 paragraph 176 ff.).

70. For this reason, the Council has advocated keeping national sovereignty over fiscal and economic policy in place and creating a long-term regulatory framework referred to as **"Maastricht 2.0"** (Annual Economic Report 2012, paragraph 173 ff., 2013 paragraph 269 ff.). ↘ FIGURE 13 This regulatory framework follows the idea of crisis prevention first and crisis management second, and consists of three pillars structured according to the responsibility allocated to European level:

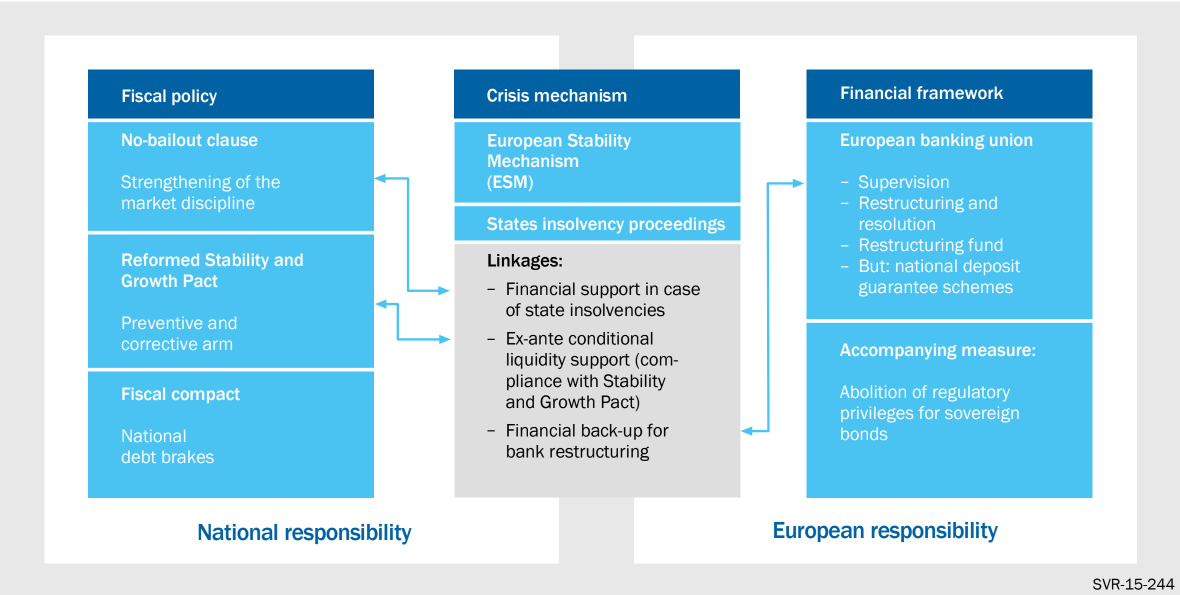
- The **pillar for the stability of the private financial system**: The danger of systemic financial crises justifies a strong governmental role for regulatory and supervisory authorities. The possibility of shifting risk from national level to the shared central bank balance sheet makes it necessary to set up a banking union with common supervisory and resolution mechanisms. This pillar has largely been implemented through the reforms undertaken in recent years. However, additional reforms are necessary to complete the banking union.
- The **pillar for crisis management**: There should be explicit rules on handling countries' liquidity and solvency crises, particularly in order to prevent the ECB from being obliged to act as crisis manager, thereby risking its independence. Like the European Stability Mechanism (ESM), the crisis mechanism should jointly make funds available, which can be drawn upon only with the approval of national governments and under strict conditionality. It should also ensure that government debt restructuring, if required to restore debt sustainability, proceeds in an orderly manner. The case of Greece suggests, however, that the exit of a member country from the euro-area has to be possible as a last resort.
- The **pillar for fiscal stability:** Fiscal policy should remain largely under national responsibility. Member countries would, however, be obliged to adopt responsible fiscal policy following three credible rules: (i) The no-bailout clause for the strengthening of the market discipline ensures that private lenders – not the other member countries – bear the consequences of

unsustainable fiscal policies. (ii) National fiscal policy is monitored on the basis of common fiscal rules of the Stability and Growth Pact (SGP) and infringements are sanctioned. (iii) National debt brakes and their monitoring prevent the accumulation of excessive public debt. The forthcoming development of the rulebook should underpin above all the credibility of the no-bailout clause.

The Maastricht 2.0 concept envisions that key aspects of economic policy and the economic policy framework, such as organisation of the labour market, remain a national responsibility.

↘ FIGURE 13

A solid framework for the Euro area: Maastricht 2.0



2. Remaining gaps in the euro area framework

71. The reforms of recent years are largely consistent with this **Maastricht 2.0 concept**. A banking union and a crisis mechanism were introduced. Tightening the SGP will result in stronger European control of national financial policy. The general economic and fiscal policy will remain national responsibility. The German Council of Economic Experts believes these reforms have already increased the stability of the framework. The framework's future stability should therefore be reassessed in view of these changes, not in relation to the pre-crisis situation.

72. As many of these reforms were implemented incompletely or too late, the ECB felt compelled to **intervene**, threatening to blur the line between monetary and fiscal policy. This particularly applies to the “whatever it takes” speech by ECB President Draghi and the related OMT announcement in summer 2012. It remains therefore necessary to close the remaining gaps in the European architecture to increase the effectiveness of the regulatory framework and to relieve the ECB in its role as a crisis manager.

Further development of the framework for financial services

73. One key objective of the euro area's revamped framework for financial services is to sever the link between banks and governments. The stability of the banking sector was improved through the implementation of **stricter banking regulation** with Basel III and the creation of a **European banking union**. This has particularly mitigated the effects of banking sector problems on governments.

74. The **Single Resolution Mechanism (SRM)** plays an important role in this. In combination with the Bank Recovery and Resolution Directive (BRRD), it stipulates that in a bank resolution, creditors are called on first to bear some of the burden (bail-in), with the rest then borne by the Single Resolution Fund (SRF). National governments are only called on for financing if the bail-in and SRF are insufficient. The aim is to decrease the burdens on governments for bank rescues by rendering crises less likely through the resolution mechanism's positive incentive effects, and by lowering the costs to be borne in the event of crisis, or even reducing them to zero.

75. However, the **effectiveness of the SRM** is still uncertain. The decision-making structures are complex and could prevent a quick reaction. Moreover, creditor participation is not yet sufficiently credible due to insufficient specificity in regulations, thus not fully ruling out repercussions for governments in case of banking problems. Also, the rules do not fully apply to all banks (Annual Economic Report 2014 paragraph 357 ff.).

This calls for a strengthening of the resolution regime. The resolution authority should be equipped with **additional powers**, so that it can also initiate and implement resolutions for smaller banks. Discretionary leeway in creditor participation should be reduced considerably. Exceptions from creditor participation should only be allowed in the case of a systemic crisis and should be accompanied by high institutional hurdles (Annual Economic Report 2014 paragraph 340).

76. **Macroprudential regulation** can also mitigate the effects of banking sector problems on governments by reducing the procyclicality of regulation, thereby preventing deleveraging which tends to exacerbates crises. The key instruments here are time-varying capital requirements (capital conservation buffer, anti-cyclical buffer) as well as increased capital requirements (Annual Economic Report 2014 paragraph 384).

77. The reverse **transmission channel of governments to banks**, in contrast, has hardly been addressed thus far. The most important problem is bank exposure to government creditors. Banks are exposed to risk of loss in the event of a sovereign bankruptcy, making restructuring of government debt more difficult. The regulatory privileges afforded to government bonds in terms of capital, liquidity and large exposures bias banks' investment behaviour toward investing in government bonds and thus affects government bond pricing. This privilege should be stopped.

78. Since the start of the crisis, many banks, particularly in the euro area, have accumulated a large exposure to domestic government bonds. This has generated considerable **large exposure risks** on bank balance sheets. Thus, high priority must be given to revising regulations regarding adequate regulatory capital and large exposure limits with regard to sovereign risks. Similar regulations should also apply to **insurance companies**.

79. **New rules** should be **in line** with other regulations (particularly liquidity regulations). Some suggestions (Brunnermeier et al., 2011; Corsetti et al., 2015) aim at creating a safe asset by pooling and tranching outstanding government bonds, simultaneously creating a liquid and safe security and achieving diversification, but without providing for joint liability.

The new regulation may increase governments' financing costs, while raising banks' capital requirements. As this could threaten the stability of governments and banks given the current situation, it is advisable to **phase in** these regulations gradually. Yet, a prompt decision on this reform is desirable for governments and market participants to be able to prepare in advance and to avoid postponing such a reform in the indefinite future.

80. For now, the German Council of Economic Experts takes a critical view of a **common deposit guarantee scheme**. On the one hand, national deposit guarantees constitute a bank-sovereign link. On the other hand, the implementation of the banking union elevated at least some control over the banking system to European level. However, national economic and fiscal policy has still considerable influence on banking sector risks. For this reason, a common deposit guarantee scheme harbours the danger of risks being transferred to the community. Moreover, all legacy problems would have to be solved first (Annual Economic Report 2012 paragraph 315).

81. There is also room for improvement in the **Single Supervisory Mechanism (SSM)**. The combination of monetary policy and banking supervision in the ECB resulting from European treaties harbours the risk of conflicts of interest (Annual Economic Report 2012 paragraph 303 ff.). This was evident for example in the ECB's approval of ELA loans in the case of Greece. The creation of an **independent European banking or even integrated financial supervisor**, which is institutionally independent from the monetary policy and which integrates micro and macroprudential supervision, is desirable (Annual Economic Report 2014 paragraph 381). However, this would require amendments to the European treaties.

In order to avoid political conflict in future on the part of the ECB, the Council considers transparent and harmonised **criteria for granting ELA loans** necessary – both in valuing of collateral and in evaluating bank solvency and liquidity. The risk that this emergency assistance could ultimately be utilised for monetary government financing should be more strictly avoided (Annual Economic Report 2013 paragraph 202 ff.). Moreover, the severe escalation of the situation in Greece could have been avoided if the ECB had capped the emergency assistance earlier.

The crisis mechanism

82. The **European Stability Mechanism (ESM)** introduced in September 2012 represents a permanent euro-area crisis mechanism, replacing the European Financial Stabilisation Mechanism (EFSF) in force since 2010. The ESM provides financial assistance under strict terms in that event crises occur that endanger overall euro-area stability. The ESM's resources are only available to countries that have ratified the Fiscal Compact. The release of funds requires a qualified majority of the votes in the ESM decision-making body, in which Germany has a veto right (Annual Economic Report 2012 paragraph 164).

83. The ESM limits the risk of contagion effects, which increases the credibility of the no-bailout clause. However, government creditors may undervalue risks due to the availability of crisis assistance, which is detrimental to the markets' disciplining function. In fact, the ESM will not bring about complete market discipline until it is complemented by **insolvency proceedings** for sovereigns where in severe crises a restructuring of sovereign debt becomes a precondition for ESM support. The current version of the treaty already mentions private creditor participation. However, this is limited to the obligatory assumption of collective action clauses (CACs) in government bond contracts. So far, these have not lead to a notable differentiation of spreads (Corsetti et al., 2015). This may be due in part to the fact that CACs do not contain comprehensive aggregation clauses, i.e. they do not automatically bind all outstanding government bonds.

84. An insolvency code for sovereigns which credibly stipulates a creditor bail-in would not only help with **burden sharing** (similar to the bail-in rules for the banking sector), but also support **crisis prevention**. An insolvency code for sovereigns gives creditors incentives to assess the default risks of government bonds and loans as accurately as possible and factor them in using risk premiums. This should result in ex ante disciplining of government budgetary policy. However, there could be an incentive for debtors that anticipate the possibility of bailing in creditors to amass even more debt. A restructuring therefore has to be accompanied by a **macroeconomic adjustment programme** that corrects these negative incentives.

85. The Council of Economic Experts has discussed possible designs for an insolvency mechanism for states in the past (Annual Economic Report 2011 paragraph 242 ff., 2013, paragraph 276 ff.). Ideally, such a mechanism should establish binding rules, setting criteria that trigger insolvency proceedings **quasi-automatically**. This would help to avoid entering a political negotiation process. The primary advantage would be reduced uncertainty to enable market participants to adjust their expectations accordingly. Costly delays could also be avoided. Further key elements of an insolvency code include measures ensuring equal treatment of creditors and thus also reducing a “rush to the exit” as well as holdout problems (Fuest et al., 2014).

86. The solution originally discussed by the German Council of Economic Experts for such an insolvency mechanism attempted to achieve such an automatism by an orientation on debt-to-GDP ratio thresholds.

The **initial idea** behind these considerations was a world in which debt-to-GDP ratios of euro member governments would all be significantly below the current figures and ideally below the 60% threshold stipulated in the Maastricht Treaty. This implies that such an insolvency mechanism could only be implemented in the distant future. In particular, the idea was to require a creditor bail-in in addition to reforms under a macroeconomic adjustment programme for crisis countries with debt ratios above 90%.

87. The already high debt levels of the euro-area members render the implementation of such an insolvency trigger impossible at this time. Introducing a rule based on public debt ratios would probably require setting a threshold as high as **current debt ratios**. The mere announcement of an insolvency regime could cause considerable turbulence on the financial markets, which makes its introduction impractical at this time.

However, waiting for a much better time for implementing such a sovereign insolvency code is not advisable either. If, in the event of a new crisis, an orderly procedure for particularly highly indebted member countries is not yet in place, it would be more difficult to avoid **obliging taxpayers** to shoulder a significant part of the burden again. This could result in another case of contentious negotiations between member countries.

88. The plan should be instead to pursue plans for a sovereign insolvency code now. However, a transition period could be included during which the insolvency mechanism gradually comes into effect. It is important to decide on the implementation of such an insolvency regime today to avoid it being postponed indefinitely. A procedure with less rigidly binding rules is preferable. However, at the same time a systematic discussion of **public debt sustainability** including the possibility of burden sharing should take place. Therefore, the European Stability Mechanism (ESM) should provide an assessment of public finances if a member state requests financial assistance. A comprehensive debt sustainability analysis would form a key part of the assessment.

If a debt crisis is determined and there is no further capital market access, the ESM may give financial assistance available on strict terms. If the ESM diagnoses an **extreme debt crisis**, for example because the sustainability analysis demonstrates that a member country can only return to sustainable public finances via debt restructuring, there will be either a one-time maturity extension of existing bonds, or if this is insufficient, a debt restructuring. This is similar to the current IMF proposal (IMF, 2014b).

In Greece, different debt operations lead to massive losses for investors in 2012. In the future, it may be expected that similar losses cannot be avoided either. For this reason, **debt restructurings** should be executed following an orderly procedures, rather than ad hoc, to make them most efficient (Zettelmeyer et al., 2013).

89. **Debt reduction** in the Monetary Union's member states would be a key step to completing the Maastricht 2.0 crisis mechanism with a sovereign insolvency code. There are no simple solutions as yet (Corsetti et al., 2015). As the German

Council of Economic Experts has explained, a European Redemption Pact would no longer work because of the existence of OMT (Annual Economic Report 2013 paragraph 260 f.). Proposals to redistribute funds from countries with lower debt to countries with higher debt through a temporary transfer are not politically feasible. Nor do they consider differences in debt sustainability, such as owed to different demographic developments. Lastly, fiscal transfers always create negative incentives for borrowers, which are unlikely to be fully addressed by an insolvency regime for sovereigns.

Thus, the Monetary Union requires member states themselves to be **responsible** for consolidating their public finances. The legacy problem of public debts cannot be solved without a willingness to consolidate on the part of the highly indebted member countries. The fiscal pillar of "Maastricht 2.0" may help them in doing so, which in light of the legacy debt problem highly important.

Strengthening the fiscal pillar

90. The reforms of the fiscal framework since the onset of the crisis have **almost completed the fiscal pillar**. The regulatory framework now in place is generally suited for improving the fiscal discipline of member states. The SGP reform which added five new provisions and one directive (the "Six Pack") in 2011, improved surveillance and coordination ("Two Pack") as well as anchoring of fiscal rules at national level through the fiscal compact in 2013 have addressed the main shortcomings of the original SGP:

- **Focus on debt sustainability** (Annual Economic Report 2012 paragraph 155 ff.): The original deficit rule contained in the SGP was not constructive as it required no correction for past deficit transgressions, nor did it take account of other effects that raise debt levels. The "Six Pack" consequently provides for implementation of a deficit procedure for exceeding the debt-to-GDP ratio of 60%, under which debt must be reduced by 1/20 of the excess.
- **Transparency and foresight**: The original deficit and debt rules were evaluated ex post and were not geared to the economic cycle or budget process. Since the first SGP reform in 2005, the economic cycle has been factored into the deficit criterion, with structural savings of 0.5% of GDP demanded if necessary. The "Six Pack" complements this with an expenditure benchmark that is binding for budget planning, and implements the European Semester to support national budget planning.
- **Sanctioning of violations:** Violations of the SGP were not consistently sanctioned. Sanctions required a majority decision of the Economic and Financial Affairs Council (Ecofin), whose members may have even voted against sanctions in their own national interest due to widespread transgressions against the SGP. The reforms tightened the corrections demanded in the SGP's corrective arm, expanded the options for sanctioning, and introduced a reverse qualified majority voting procedure. Doubt remains, however, as to whether the sanctions will lead to the desired improvement of fiscal discipline and whether they provide sufficient protection against an uncooperative member country.

91. **Improvements** are needed for the reformed fiscal pillar to effectively prevent a repeat of undesirable fiscal developments. The rules need to be simplified in order to limit destabilising discretionary leeway, such as in forecasting the economic cycle and structural budgets. It is particularly important for the credibility of fiscal rules that the responsible European institutions – Ecofin and the European Commission – consistently apply the existing rulebook in order to maintain fiscal discipline.

92. Toleration of temporary deviations, e.g. in the cases of France being granted longer to achieve the deficit limit under the SGP's corrective arm (European Commission, 2015a) and Italy for compliance with the 1/20 debt reduction rule under the SGP's preventive arm (European Commission, 2015b), is a repetition of past errors. **Compliance in regard to reducing structural deficits** is particularly important in view of the high debt ratios of many euro-area members, which continue to hamper economic recovery and cast doubt on the stability of the Monetary Union. Even if not obvious to individual member states, the future of the euro area will depend on consistently reducing legacy debt.

93. The Greek crisis has demonstrated that the credibility of the no-bailout clause depends on the willingness of a member country receiving financial assistance to **cooperate** under the terms of an adjustment programme. If a country does not want to cooperate at all, its membership in the currency union is put into question. The exit of a member country from the Monetary Union is a violation of the treaty and thus European law. This also applies to a member country introducing its own or a parallel currency. The Treaty on the Functioning of the European Union (TFEU) does not provide an **exit** option, because in this case it could trigger speculation about the remaining in the Monetary Union among other member countries that have economic problems in the future.

However, the permanent lack of willingness to cooperate on the part of a member country could undermine the currency union's architecture to such an extent that its very existence is under threat. The currency union's member states would be susceptible to blackmail. In such cases, a country's exit from the Monetary Union must be possible as a **last resort** (ultima ratio). In this event, measures must be taken for the exit to be completed in an orderly manner and for the member country to receive economic support to avoid humanitarian disaster.

3. Instability due to premature integration steps

94. The German Council of Economic Experts takes a critical view of the calls for a common fiscal policy at European level. It does not consider the creation of a **fiscal capacity** necessary or the ultimate aim (Feld and Osterloh, 2013; Annual Economic Report 2013 paragraph 324 ff.). Advocates of this instrument assume that it would enable a smoother adjustment to country-specific shocks within the Monetary Union, which without currency union could largely occur via currency adjustments. However, well functioning markets for goods and production fac-

tors should be equally effective compared to exchange rates for smoothing shocks.

95. The basic idea that a country with an expanding economy directs fiscal transfers to a country under worse economic conditions **contradicts the idea of Maastrict 2.0** and is suffering from serious complications.

First, it is thus doubtful that country specific shocks and their compensation through a fiscal capacity can be measured with sufficient precision. Moreover, the fiscal capacity could lead to significant redistribution effects in the form of permanent unilateral transfers between countries. The problem would arise, for instance, because of difficulties to measure production gaps in real time. Harmful incentive effects would ultimately arise, as countries would limit their own efforts to reducing their susceptibility to shocks.

96. Second, it can be expected that economic integration and hence the adaptability of monetary unions increase over time (Frankel and Rose, 1998). In Europe, there are many other channels available to cushion against country-specific shocks, in particular financial markets. Studies for the United States show that the capital and credit markets, rather than transfers or the federal budget, provide the lion's share of shock absorption (Feld and Osterloh, 2013). For the European Monetary Union, promoting financial integration is thus of great importance to ensuring adaptability to shocks. Not least, a reducing of their excessive debt will create future leeway for member countries, enabling them to utilise their own fiscal policy for shock absorption (Annual Economic Report 2013 paragraph 335 ff.). Consequently, a **fiscal capacity is not necessary**.

97. The same applies to the proposal of a **European unemployment insurance**, which was frequently discussed during the crisis. This could, in principle, be an automatic stabiliser to help offset country-specific shocks in euro-area member countries. In contrast to transfer payments at macroeconomic level, such insurance would make payments at individual level. A European unemployment insurance should be rejected under Maastricht 2.0 for three reasons (Annual Economic Report 2013 paragraph 327 ff.):

Firstly, national unemployment insurance schemes are structured very differently, for example in terms of benefit amounts, eligibility requirements and those insured. Moreover, unemployment insurance must be in line with a country's other labour market institutions, as well as the tax and transfer system. Establishing a European insurance system is therefore hardly **feasible from an institutional point of view**.

Secondly, it would likely result in **redistribution effects**, even if the insurance benefits were kept to a minimum in terms of amount and duration. Simulation studies, however, yield a variety of results (Rhein 2013; Fichtner and Haan 2014; Dolls et al., 2014). Acknowledging that the reasons for unemployment are not exclusively cyclical but also structural, a European insurance mechanism would then lead to permanent transfer payments.

Thirdly, a European unemployment insurance scheme would be accompanied by **major incentive problems**. More than hardly any other policy area, the structure of the social and labour market policy lies purely in the interests of each member country. It is thus advisable to keep any transfer payments as transparent as possible at the macroeconomic level – for example, via the structural and investment funds or a crisis mechanism.

98. Moreover, deepening European integration via greater harmonisation of economic policy is frequently proposed in current discussions. One prominent example of this idea is the Macroeconomic Imbalance Procedure (MIP), which is intended to serve in the European Union as an **element of economic policy surveillance**. The objective of the MIP is to identify macroeconomic imbalances by means of a scoreboard of ten macroeconomic indicators published by Eurostat. The final outcome of an "excessive imbalance", however, is determined primarily on the basis of a qualitative overall assessment.

99. This includes **in-depth reviews** by the European Commission for those member countries threatened by imbalance. At the start of an assessment, the member country in question is expected to submit and implement a corrective action plan with a clear roadmap for the imbalance detected. However, the European Commission may merely make recommendations. Only in the case of inadequately implemented measures, the Ecofin can decide to impose a **sanction** at the recommendation of the European Commission by reverse qualified majority voting. This is initially an interest-bearing deposit of 0.1% of GDP, and for repeated non-compliance, an annual fine of the same amount.

100. The German Council of Economic Experts welcomes the **high visibility** of the scoreboard. Macroeconomic developments of the member countries are analysed using several indicators and sensitise the public-at-large to country-specific problems. However, this procedure comprises a fundamental problem arising from the incorrect assumption that all undesirable macroeconomic developments arise from **poor policies**. Moreover, there is the false impression that a member country can always help to correct certain macroeconomic figures by implementing better policies. This would not be the case, for example, with respect to the German current account surplus (Annual Economic Report 2014 paragraph 400 ff.).

Criticism should also be levelled at the European Commission for having a toolkit including the possibility of sanctions which increases its influence on domestic economic policies in member states. The German Council of Economic Experts therefore argues **against stronger binding effects** resulting from the MIP.

101. Calls surface time and again in the European debate for stronger **international coordination of wage-setting** on the labour market. It was recently proposed that minimum wages in France and Germany should be coordinated or a heavier focus should be placed on international price developments in national wage negotiations in order to avoid euro-area imbalances. In connection with the latter point, the report of the five presidents, for instance, suggests creating national,

independent authorities to strengthen competitiveness (Junker et al., 2015). These institutions' responsibilities should include monitoring wage and productivity development in their national economies and issuing statements to be used as guidelines in wage bargaining.

The German Council of Economic Experts takes a **very critical view** of these proposals. It should be assumed that employers and employees ultimately take all important macroeconomic developments into account in their negotiations. Not least, the MIP has recently contributed to this. Moreover it seems rather bold to expect companies in their decisions to take into account competitors in other euro-area countries. Wage-negotiating parties are solely obligated to protect the interests of those they represent. For this reason, member countries need to identify suitable reforms and implement them to safeguard their international competitiveness (Annual Economic Report 2013 paragraph 279).

VI. SUMMARY AND OUTLOOK

102. The crisis in the euro area has revealed two **fundamental problems** in the design of the common currency zone. Firstly, there was a lack of economic and fiscal policy discipline. And secondly, there was no credible mechanism for crisis response. These institutional deficits contributed to economic imbalances in the economically heterogeneous currency area, which made the economies of some member states vulnerable to shocks and contributed to the deepening of the crisis. As a result of the global financial crisis, these developments triggered severe crises in Greece, Ireland, Portugal and Spain and ultimately threatened the cohesion of the entire euro area.

103. Given these developments, **macroeconomic adjustment** was unavoidable in the crisis countries. This included fiscal consolidation and structural measures to enhance competitiveness. These steps were associated with painful cutbacks straining the social cohesion in the affected countries.

To support the crisis countries in their adjustment and stabilise their financial systems, **adjustment programmes** were agreed. These programmes were adopted by democratically legitimised representatives of both the creditor and recipient countries and followed the “loans for reforms” rationale. The crisis countries retained ownership to implement the reforms. The success of this model therefore required **credible willingness and capacity to reform**.

104. Ireland, Portugal and Spain all successfully completed their programmes. However, the lack of progress and recent turbulence in Greece have prompted voices to question rescue policy in its entirety. Yet the situation in Greece should not be taken as proof of failure of the **rescue policy** as such. Firstly, the rescue policy of 2010-2014 averted a systemic crisis and thus maintained the cohesion of the Monetary Union. Secondly, the time was used to implement reforms to make the Monetary Union more resilient against economic crises. Thirdly, Ireland, Portu-

gal and Spain were able to durably win back investors' trust. Their economies are now rebounding, although unemployment remains high.

105. It has become evident in recent years that the euro-area member countries currently are predominantly unwilling to give up national budget autonomy. For this reason, the German Council of Economic Experts has advocated keeping **national sovereignty** over fiscal and economic policy in place for as long as there is no serious prospect of effectively transferring this sovereignty to the European level. However, this does not imply giving up on establishing a stable and coherent regulatory framework for the monetary union, which complies with the principle of unity of liability and control.

To provide such a stable framework for the Monetary Union, the German Council of Economic Experts has developed a long-term framework (“**Maastricht 2.0**” see Annual Economic Report 2012 paragraph 173 ff., 2013 paragraph 269 ff.). The reforms of the recent years were largely consistent with this model: Tightening the SGP with new rules will result in more stringent control of national fiscal policy. A crisis mechanism and a banking union were introduced. General economic and fiscal policy, however, remained national responsibility. These reforms have made the policy framework much more stable.

106. However, some of the reforms remain incomplete. The **banking union** in its current form requires further development. The following measures would be particularly desirable:

- Creation of an independent European banking or even integrated financial supervisor, which is institutionally independent from monetary policy and which integrates micro and macroprudential supervision;
- Enhanced competencies for the resolution authority, including for smaller banks;
- A reduction in the discretionary leeway for creditor participation.

Moreover, the problem of the **bank-sovereign nexus** has yet to be fully solved. The risk weightings for government bonds in the capital requirements should therefore be adjusted. Limiting the exposure to government bonds in line with common large exposures limits would be advisable.

107. The **ECB was forced to assume the role of crisis manager** during the crisis and took actions at the limits of its mandate. ECB President Draghi's announcement to do “whatever it takes” to preserve the euro area’s integrity may have calmed the financial markets, but it sent the wrong signal as regards fiscal consolidation. In order to avoid this, **fiscal rules must be strictly observed**. This is the only way to address the legacy of high public debt ratios.

108. For the no-bailout clause to become credible, an **insolvency mechanism** needs to be introduced that requires a maturity extension of government bonds as part of future adjustment programmes if public debt is not deemed sustainable. In the event of severe public debt overhang or a material breach of fiscal

rules, an ESM adjustment programme should only be approved after a debt haircut is imposed on private creditors.

109. The experience with Greece showed that a member country's unwillingness to cooperate over an extended period can create an existential threat to the stability of the Monetary Union. If there is no possibility of a country exiting the single currency, the remaining member countries are susceptible to blackmail. A country's exit from the Monetary Union must therefore be possible as a **last resort** (ultima ratio). A further reason for this is that the populations of other member countries will be unwilling to provide unlimited financial support to individual member countries. The democratically legitimated governments of the countries bearing the financing burden must take this into account in negotiations. There could also be spillover effects on other EU countries, in particular the UK, which threaten to becoming increasingly politically alienated from the EU.

110. The current turbulence in Greece should not be the cause for **hasty moves towards closer integration**. The German Council of Economic Experts thus repeats its criticism of proposals that cannot be reconciled with the unity of liability and control and instead stray further away from this principle:

- **Creation of a fiscal capacity**: The concept of fiscal transfers from countries with above-average economic performance to countries with weaker economic performance is impractical given measurement problems, creates false incentives, and harbours the risk of permanent unilateral transfers (Annual Economic Report 2013 paragraph 324 ff.). This also applies to the potential creation of a European unemployment insurance scheme.
- **Stricter obligation of the Macroeconomic Imbalance Procedure**: The Macroeconomic Imbalance Procedure (MIP) is a component of economic policy management in the European Union. The high visibility of the scoreboards of macroeconomic indicators used by the MIP are useful in identifying economic imbalances. However, not all undesirable developments are attributable to poor economic policies or can be corrected by government intervention (Annual Economic Report 2012 paragraph 168).

111. Given the acute threat to the cohesion of the common **monetary area** resulting from the crisis in Greece, consideration must now be given to the reforms to prevent a repeat.

However, reforming the single currency's framework cannot be justified solely by the desire to send a positive signal for European integration. For as long as member countries are unwilling to **transfer national sovereignty** over economic and financial policy to the European level, all reform proposals must withstand a critical evaluation of the **incentives they set for national economic and financial policy**. The institutional framework of the single currency area can only ensure stability if it follows the **principle of unity of liability and control**. Reforms that stray from this guiding principle plant the seeds of further crises and may damage the process of European integration, despite their intentions.

A different opinion

One member of the Council, **Peter Bofinger**, does not agree with the concept for further institutional development of the European Monetary Union (EMU) outlined by the majority of the Council members in this special report.

1. On the further development of the European Monetary Union

112. The Greek crisis raises questions regarding **fundamental reforms** of the institutional structure of the Monetary Union. The key question is whether a monetary union can survive in the long run without a political union. Unlike many economists (Issing, 2004), the majority of Council members believe that a stable and coherent regulatory framework for the Monetary Union can still be put in place even without the effective transfer of sovereignty to European the level.

113. The solution thus proposed by the majority, the "**Maastricht 2.0**" concept it developed in 2012, largely corresponds, with some modifications, to the institutional status quo. The key innovation is an **insolvency mechanism for sovereigns**. The procedure advised for this involves a systematic discussion of debt sustainability including potential participation of private creditors. It is vital that the decision on implementation of the insolvency regime be made now, to avoid it being postponed indefinitely. However, the majority leaves the specific details on the structure of this mechanism completely open.

By contrast, the majority considers all proposals unrealistic that would result in a **transfer of national sovereignty** of economic and fiscal policy to the European level, and thus in reinforced and improved democratic legitimation of European political decision-making processes.

114. The regulatory concept which the majority advocates to strengthen the Monetary Union is thus largely characterised by **confidence in the market's stabilising powers**. Rather than "dealing with political partners when it comes to payment obligations, the individual member countries in this system must face anonymous financial markets." If liability for other member countries were credibly excluded, "financial markets [can] exercise their disciplining function by imposing higher risk premiums on government bonds, thereby demanding fiscal discipline by euro area members".

115. There has been little evidence thus far to support the majority's marked confidence in market processes as a basic regulatory principle of a monetary union:

- The **Delors Report** (Committee for the Study of Economic and Monetary Union, 1989), which set out the blueprint for European monetary union back in 1989, found the disciplinary effects of market forces to be either too slow and weak, or too sudden and destructive. The very low risk premiums for

Greek bonds for many years were an impressive confirmation of this prediction.

- The **financial crisis,** which hit Spain and Ireland harder than any other euro-area countries, was triggered largely by private investors making bad decisions. It seems somewhat paradoxical that players who were saved by large injections of cash from the state are now to be used by the very same state as referees ensuring appropriate macroeconomic policy.
- The **crisis developments leading up to July 2012** confirm the Delors Report prediction that once market reactions start, they are so abrupt and destructive that governments are no longer able to react adequately to them. Hence, the rescue of the Monetary Union was only possible thanks to the committed intervention of Mario Draghi, and in particular the announcement of Outright Monetary Transactions (OMT). A de facto guarantee of European government bonds was the only way to stop the vicious circle of rising bond yields, lower debt sustainability, the firesales of government bonds and rating downgrades. Thus the fact that the Monetary Union did not collapse in summer 2012 is only due to an infringement of the "principle of unity of liability and cntrol", so highly regarded by the majority.

116. Therefore, the conclusion regarding **the institutional status quo** is that it would not have been able to survive had the ECB not been prepared to intervene forcefully on financial markets. The instability of the status quo in the event of large-scale disruptions on the financial markets comes as little surprise, as the euro member states are subject to **a specific insolvency risk** that does not arise for similar countries to the same extent.

This risk arises because countries joining the Monetary Union converted all of their sovereign debt, which was previously denominated in their national currency, into euros. This removes the option of repaying the sovereign debt via funding from that country's own central bank in an emergency. This highlights one of the fundamental differences between the member countries of the Monetary Union and other highly developed countries such as the United States, Japan and the United Kingdom. Ultimately , the member countries are in a situation normally reserved for emerging economies, which are incapable of incurring debt in their own currency.

The particularly high **exposure to the financial markets** is further exacerbated by the fact that, within the monetary union, investors in one country are able to switch from bonds issued by their own government to bonds issued by another member country at any time without being exposed to currency risk. By contrast, Japanese investors, for example, have only limited options for switching to bonds issued by other countries as a result of currency risk.

117. The key institutional change from the status quo that the majority is calling for in this special report is an **insolvency mechanism for government bonds**, without specifying this in further detail. The majority seems to assume that this would change the overall euro-area framework in such a fundamental way that we would no longer see self-reinforcing bond runs on the euro-area bond markets.

Given the specific insolvency risk for euro-area member countries, however, this kind of insolvency mechanism could cause precisely the opposite. Market participants would then have to assume that government bonds would always be restructured as soon as a country comes under pressure on the capital markets. This could trigger an unstoppable bond run following even minor shocks. Of course, the ECB could in turn intervene, but this is precisely the type of action that the Council's majority vehemently rejects.

118. Moreover, such an insolvency mechanism would deprive member countries with higher debt levels of the option of using high government deficits to react to a severe recession. The experience of 2009/10 shows that a high dose of an **anti-cyclical fiscal policy** was key in preventing a repeat of the Great Depression. In the Maastricht 2.0 world, countries with high debt-to-GDP ratios would have to expect markets to panic at any time, triggering a self-reinforcing bond run.

119. In a situation in which general confidence in the cohesion of the Monetary Union is already damaged, not least as a result of the discussion on a temporary Greek exit from the euro area, a political **initiative for a sovereign bankruptcy regime** could have devastating consequences. Therefore, the answer to the crisis in Greece must not be to weaken the stability of the Monetary Union by increasing the risk of default of public euro-area bonds. The real task in hand is actually to eliminate the major weaknesses in the institutional framework. For this to happen, courageous steps need to be taken towards a **fiscal union**.

120. In particular, the Monetary Union should be developed further to make it just as robust as other major monetary areas in the event of large-scale financial market shocks. Government bonds issued by the United States, Japan and the UK are basically 100% safe in terms of their nominal redemption amount. Therefore, they serve as a major **pillar of stability for the financial systems** of these countries. Furthermore, the governments of these countries were able to use unusually high state budget deficits to stabilise the situation in reaction to the "Great Recession" of 2008/2009.

121. Looking at the euro area, a similar situation could be created by ensuring that **joint liability** is assumed for at least parts of the government bonds in the member countries. In its Annual Economic Reports for 2011 and 2012, the German Council of Economic Experts outlined the model for a "**Redemption Pact**". The idea behind this proposal is for debt that exceeds the Maastricht Treaty reference value, i.e. 60% of GDP, to be transferred to a common redemption fund with joint liability. A consolidation plan should be agreed upon for each country to repay the transferred debt within a period of 20 to 25 years. One of the key motivating factors behind the proposal was an attempt to prohibit the **purchase of securities by the ECB** (Annual Economic Report 2011 paragraph 186).

122. Since joint liability also undoubtedly calls for **joint responsibility**, any form of shared liability must come hand-in-hand with the transfer of fiscal policy sovereignty to the European level. The majority of the Council members rightly point out that there is little enthusiasm for such a step at this time. However, countries would be more willing to give up fiscal policy sovereignty if, in return, joint lia-

bility and, as a result, better protection against financial market disruptions were achieved. The transfer of sovereignty need not include the scope and structure of national spending and revenue. It could be limited to setting a permissible debt level for a certain country within existing rules and if necessary agreeing on tax increases for a limited period, for example, under rights of intervention.

123. In its previous reports, the German Council of Economic Experts called for the establishment of a **Commissioner for Economic and Financial Affairs** endowed with the same powers as the Commissioner for Competition, whose decisions do not have to be approved by the Council of Ministers (Annual Economic Report 2011 paragraph 208). The Commissioner for Economic and Financial Affairs should be equipped with the right to initiate infringement proceedings at the European Court of Justice against member countries that do not comply with the rules. The Council has also considered the model of a **European Finance Minister** who would be responsible for economic and monetary policy for the EMU (Annual Economic Report 2011 paragraph 210). One of the main reasons behind these considerations was the fact that an intergovernmental body like the Economic and Financial Affairs Council (Ecofin) cannot be expected to impose consistent sanctions.

124. Consequently, transferring power for procedures and sanctions under the Stability and Growth Pact to a **supranational institution** would not only allow forms of joint liability to be established within the Monetary Union, but would also lay the foundation for more effective sanctions to be imposed on countries that violate the fiscal policy rules. This is precisely what was not done in Greece's case. It was very clear there over a period of several years, that the budget deficits reported ex post were much higher than those initially published. Nevertheless, the country was released from the deficit procedure without any sanctions in 2007 based on the data available at the time for 2006 and 2007.

125. The majority of Council members point out that a **transfer of national sovereignty** for economic and fiscal policy is currently neither up for debate nor likely to be democratically legitimised. However, if we remain in the status quo and even more so if we implement an insolvency regime that increases the risk of default on government bonds, it is not possible to rule out a scenario in which the stability of the currency union cannot be secured in the event of large-scale disruption on the financial markets. If a larger member state were to be confronted with a bond run, even the ECB could soon reach the legal limits of its room for manoeuvre.

2. On the proposal for a European fiscal capacity

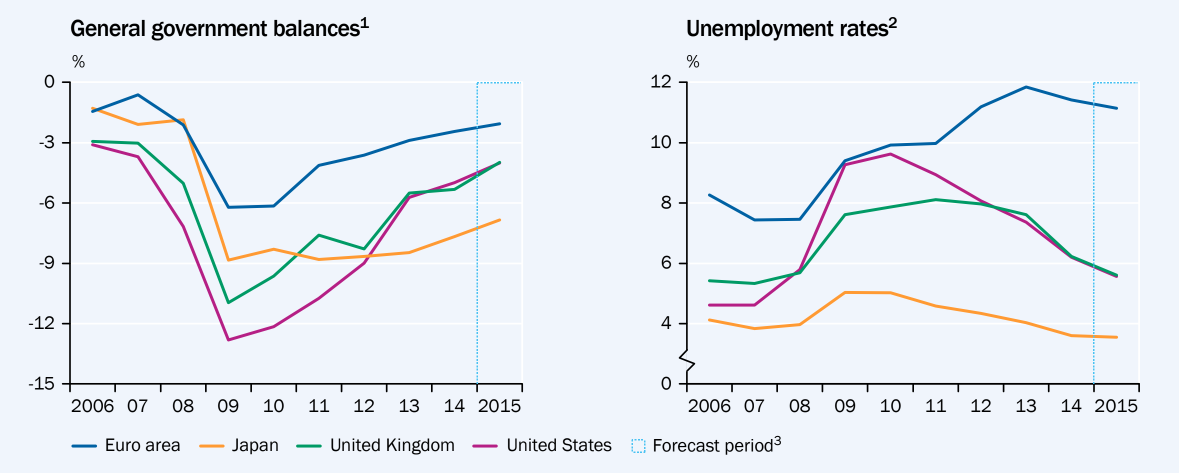
126. This Council member does not agree with the majority of Council members' rejection of a European **fiscal capacity**. ↘ PARAGRAPH 96 After the experience of the past five years, it is difficult to find empirical evidence to support the implicit assumption that the European Monetary Union's adaptability has increased over time, thus rendering joint stability mechanisms unnecessary. The majority's reference to the fact that member countries reducing their excessive debt would

create leeway for them to utilise their own fiscal policy for shock absorption in future is not incorrect. However, it would take most countries decades to achieve such a situation.

127. The need for a **common stabilising function** for the euro area, as proposed in the "Five Presidents' Report" (Juncker et al., 2015), or at least for a much closer cooperation on economic policy, is due to the fact that to date the Monetary Union has not yet achieved **effective coordination of national fiscal policies**. As already explained in the Delors Report, this is a key requirement for domestic economic balance within the euro area. The **European Semester**, which by design would be suited for this coordination function, has also proven completely inadequate thus far (Bofinger, 2014). The improved structuring of the European Semester proposed in the "Five Presidents' Report" (Juncker et al., 2015) is therefore a step in the right direction.

128. The insufficient fiscal policy coordination is clearly reflected in the development of fiscal balances since the beginning of the global financial and economic crisis. The **anti-cyclical reaction of fiscal policy** was far more tepid and short-lived in the euro area than in other major economic areas. ↘ FIGURE 14 Consequently, euro-area unemployment has only slightly receded from its high, whereas in other monetary areas it has almost returned to pre-crisis level.

↘ FIGURE 14
General government balances and unemployment rates



1 – In percent of GDP. 2 – In percent of labour force. 3 – Forecast of OECD.

Source: OECD

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3. On the austerity debate

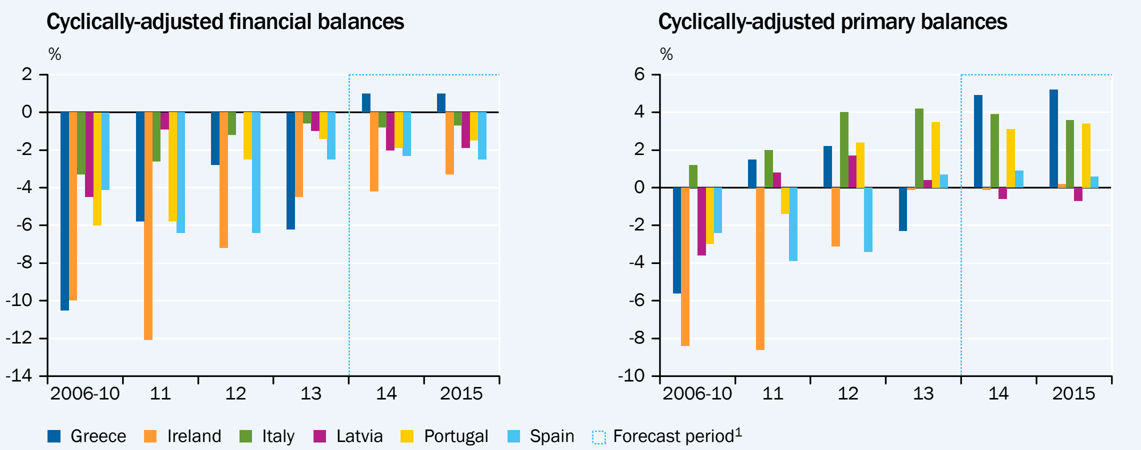
129. The majority of the Council members critically discusses the opinion that austerity policy, i.e. calls for a rapid deficit reduction, is more of a hindrance than a help to growth and, as a result, crisis resolution.

However, the majority fails to consider that **Spain** in particular, which it cites as a success model, has benefited considerably from not implementing any further austerity measures since 2013. Since then, the country has not reduced its cyclically-adjusted deficit any further, although its deficit is extraordinarily high in an international comparison, amounting 5.8% in 2014 and an estimated 4.5% this year. Spain has used this fiscal leeway not least for demand-oriented measures. It most recently boosted its automotive industry by implementing a total of eight programmes featuring "car scrappage bonus" **incentives**, which resulted in a large increase in sales.

130. The development of the cyclically-adjusted **budget balance** and cyclically-adjusted **primary balance** shows that far lower austerity and consolidation efforts were demanded from Portugal, Latvia, Ireland, Italy and Spain than from Greece. ↘ FIGURE 15 In this respect, there are many arguments to support the theory that excessive debt reduction only serves to exacerbate a crisis.

↘ FIGURE 15

General government financial and primary balances
in percent of potential GDP



1 – Forecast of the European Commission.

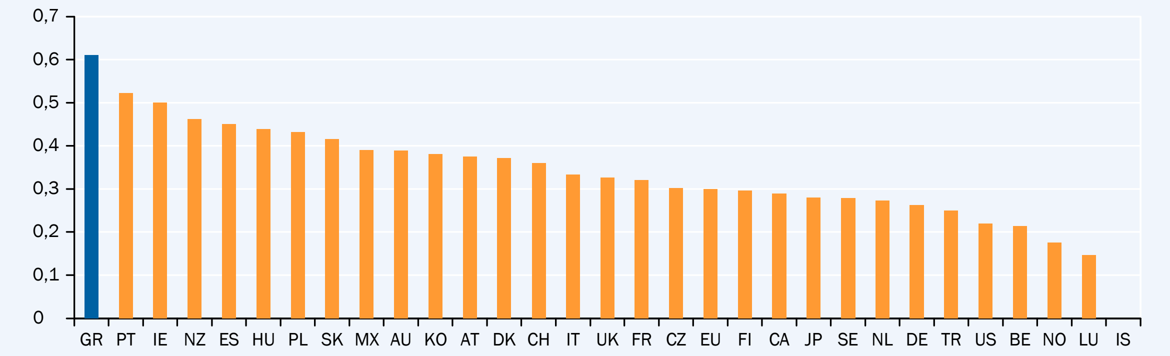
Source: European Commission

SVR-15-258

131. In this context, it is also important to consider the majority's theory that Greece has **implemented reforms insufficiently** compared with the successful efforts by Spain, Ireland and Portugal. The empirical evidence does not support this view. According to the OECD's Reform Responsiveness indicator, Greece has undertaken many more reforms than other crisis countries since 2007. ↘ FIGURE 16

↘ FIGURE 16

Overall reform responsiveness over the period 2007-14[1]



1 – GR-Greece, PT-Portugal, IE-Ireland, NZ-New Zealand, ES-Spain, HU-Hungary, PL-Poland, SK-Slovakia, MX-Mexico, AU-Australia, KO-Republic of Korea, AT-Austria, DK-Denmark, CH-Switzerland, IT-Italy, UK-United Kingdom, FR-France, CZ-Czech Republic, FI-Finland, CA-Canada, JP-Japan, SE-Sweden, NL-Netherlands, DE-Germany, TR-Turkey, US-United States, BE-Belgium, NO-Norway, LU-Luxembourg, IS-Iceland.

Source: OECD

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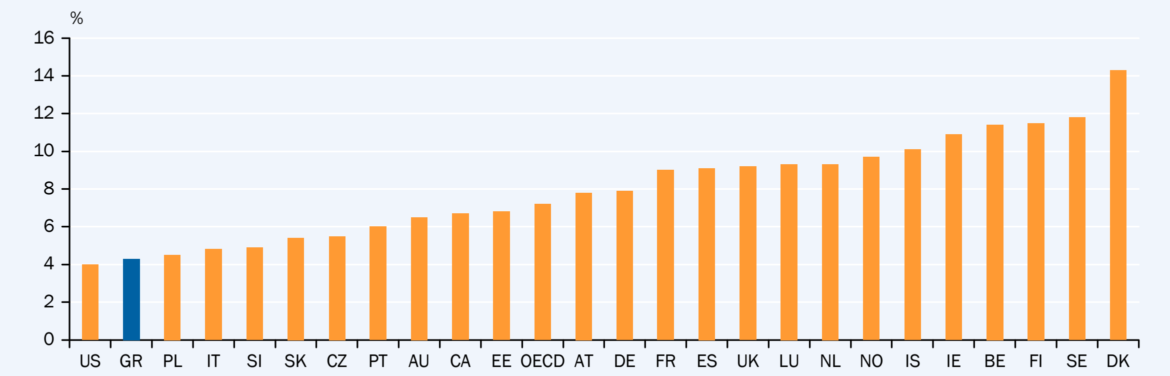
132. The structural reform debate generally suffers from the fact that the many individual measures are not assessed in detail. From a German perspective, it would be tempting to recommend that Greece should particularly implement policies along the line of Germany's **Hartz IV reforms** in order to give the unemployed a real incentive to seek work. It is important to remember, however, that unemployed people in Greece do not receive any state support whatsoever after being unemployed for 360 days. This also explains the fact that state social security benefits in Greece (excluding spending on the pension insurance and healthcare system) are much lower than in other European countries. ↘ FIGURE 17 In this respect, Greece has done its "homework" more rigorously than Germany.

↘ FIGURE 17

Social welfare benefits in the year 2009[1]

in percent of nominal GDP



1 – Excluding pensions and health. US-United States, GR-Greece, PL-Poland, IT-Italy, SI-Slovenia, SK-Slovak Republic, CZ-Czech Republic, PT-Portugal, AU-Australia, CA-Canada, EE-Estonia, AT-Austria, DE-Germany, FR-France, ES-Spain, UK-United Kingdom, LU-Luxemburg, NL-Netherlands, NO-Norway, IS-Iceland, IE-Ireland, BE-Belgium, FI-Finland, SE-Sweden, DK-Denmark.

Source: OECD

SVR-15-256

4. Summary

133. Over the past few years, Germany has reaped the economic benefits of membership in the European Monetary Union like no other country. An uncontrolled collapse of the euro would therefore hit the German economy particularly hard. Despite all of the likely difficulties on the road towards greater integration, German policymakers should have a vested interest in systematically stabilising the architecture of the European Monetary Union after the upheaval of the Greek crisis.

This means charting a fundamental **ordo-political decision**. Should Europe be disciplined by "anonymous financial markets" in future, or should it be shaped by democratically legitimised political processes? As Foucault put it (2004), the question is whether we want to have a state under supervision of the market or a market under supervision of the state. If the return to national currencies is rejected, then a choice has to be made between financial market dominance and transferring certain sovereign rights to European level. Giving up national sovereignty is a lesser sacrifice than may appear at first glance. Those subject to the erratic processes of the financial markets ultimately do not enjoy any worthwhile form of material sovereignty.

After the experience of the financial crisis and the destabilising processes in the period from 2010 to July 2012, there are few arguments for greater confidence in the formative processes of the financial markets—as proposed by the majority of Council members. The **road to greater political integration** in Europe is hard, but there is no real alternative.

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