

SECOND CHAPTER

European economic policy: Stable architecture for Europe

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Bibliography

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At a glance

In the first half of 2012, the crisis of the European Monetary Union (EMU) escalated further. The tensions only began to ease after the European Central Bank (ECB) announced it would buy unlimited amounts of bonds if necessary through its Outright Monetary Transactions (OMT) programme. An additional **positive sign** is the reduction of current account deficits in the crisis countries. But it would be premature to say the trend has already been reversed. It has not yet proved possible to break the **vicious circle** comprising the macroeconomic crisis, banking crisis and sovereign debt crisis. In Greece, Italy, Portugal and Spain the economic situation deteriorated unexpectedly sharply in 2012. Average euro-area unemployment rose to 11.6 %. The situation of the banks in the crisis countries has worsened markedly. Despite decisive austerity programmes, government debt levels have increased significantly.

As the uncertainty of the markets continued into the summer months, the **ECB** was forced more and more into the thankless role of stabilizing the financial markets through refinancing of banks, sovereign bond purchases and, finally, the announcement that it was ready to buy unlimited amounts of bonds. But in a setting of high unemployment, weak credit growth and a moderate expansion of the monetary aggregate M3 which is an indicator of inflation, prices in the euro area are unlikely to accelerate strongly in the foreseeable future. This does not rule out inflationary dangers in the medium to long term. Those will depend on the euro area's ongoing crisis management.

Economic policymakers in Europe are thus confronted with the tough task of taking the right steps to stabilize the situation in the euro area in the short run. At the same time, the work on building a **stable architecture** for EMU needs to be resolutely continued, as this is vital for ensuring a stable long-term regulatory framework.

In the long run, the sole stable constellations are ones in which liability and control stay together. A majority of the members of the German Council of Economic Experts (GCEE) endorse an arrangement in which fiscal and economic policy remain largely under national sovereignty in the long term in keeping with the principles enshrined in the Maastricht Treaty, albeit with improved fiscal rules in the EU. The GCEE therefore reaffirms the **three-pillar model** that it first proposed in its 2010 Annual Report. The first pillar, for strengthening fiscal stability, requires credible fiscal rules which provide incentives for pursuing a sound fiscal policy and, where necessary, effectively punish countries with insufficient fiscal discipline. The second pillar, for strengthening the stability of the financial system, requires a uniform financial supervision equipped with extensive competencies and powers of intervention. The GCEE proposes the concept of a banking union for this. The third pillar, for strengthening crisis resolution, requires a regulatory framework for dealing with sovereign liquidity and solvency crises in order to, first, effectively counter contagion effects and, second, facilitate orderly sovereign defaults.

Policymakers have already taken some crucial steps towards this model labeled "Maastricht 2.0". Despite the necessary criticism of certain details, reforms have been initiated which would have been unthinkable not long ago. But there is still a missing link: a credible fiscal strategy that plots a path out of the current crisis. This requires building a fiscal bridge leading convincingly from the necessary short-term stabilization measures to a long-term stable framework for the euro area. The **Council of Economic Experts' European Redemption Pact** offers such a suitable framework. It is designed as a system of mutual obligations for solidarity and solidity, featuring joint liability in a European Redemption Fund – limited both in amount and time – connected with strong safeguards to the European Redemption Pact.

I. Euro crisis in its third year: Few positive signs so far

105. In the first six months of 2012, the crisis in the European Monetary Union (EMU) escalated further. After the European Central Bank (ECB) announced it would buy unlimited amounts of bonds if necessary through its Outright Monetary Transactions (OMT) programme, tensions eased appreciably during the summer of 2012. A further factor contributing to the tension release was the impressive reduction of the crisis countries' current account deficits. Another hopeful sign is Ireland's comparatively positive economic development. Despite these chinks of light, however, it would be premature to suggest that the crisis is already solved. The economies of Greece, Italy, Portugal and Spain have deteriorated unexpectedly strongly in 2012, and unemployment has risen appreciably. The situation of some banks in these countries has worsened substantially. Despite decisive austerity programmes, government debt levels have increased significantly.

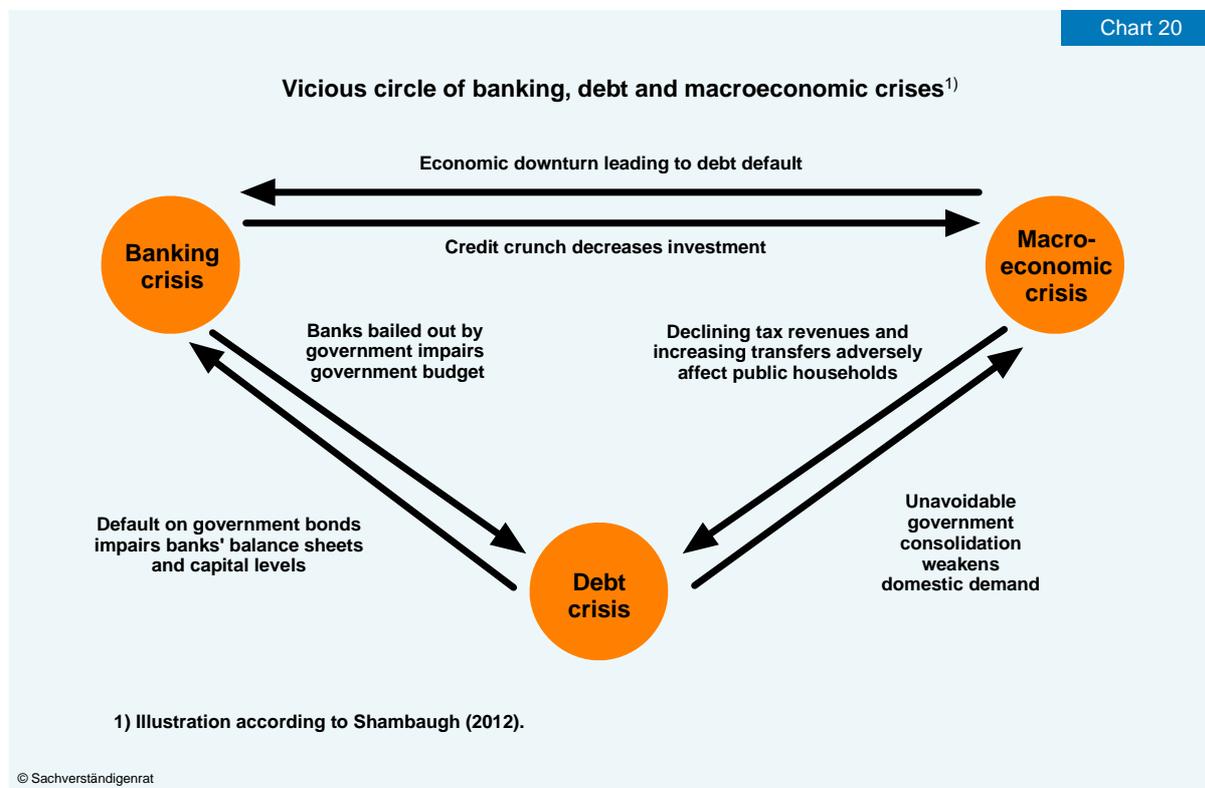
106. Although European policymakers took an important step towards strengthening fiscal discipline in EMU by adopting the Fiscal Compact, they did not move forward to underpin the national consolidation efforts through forms of joint liability, as could be achieved by the European Debt Redemption Pact devised by the German Council of Economic Experts. As market uncertainty continued into the summer months, the ECB – being the euro area's only institution fully capable of acting – was therefore forced more and more into the thankless role of stabilizing the financial markets through bank refinancing, sovereign bond purchases and, finally, the announcement that it was ready to buy unlimited amounts of bonds.

107. The term "euro crisis" conflates **three major trouble spots** that are closely interconnected (Chart 20). Going into the summer, these led to a serious crisis of confidence in the continued existence of the EMU:

- The **sovereign debt crisis**, which is characterized by rapidly rising debt-to-GDP ratios and some crisis countries' high risk spreads over German Bunds, which continue to be perceived by investors as a safe haven.
- The **macroeconomic crisis**, which is reflected in the recessions that are gripping more and more member states and in high and further rising unemployment rates, especially in Spain and Greece. These short-term developments are accompanied by longer-term problems of **international competitiveness** that are due mainly to excessive wage costs. This makes it hard for the crisis countries to offset the drop in domestic demand accompanying the restrictive fiscal policy through higher exports.
- The **banking crisis**, which is marked by investors' and savers' persistent mistrust in financial institutions in the euro-area crisis countries and a renationalization of credit relationships.

The key economic policy challenge is to come up with solutions to the crisis that break through the vicious circle of these three interconnected trouble spots. The necessary consolidation programmes carry a risk of amplifying the macroeconomic crisis. This, in turn, impacts

negatively on the situation of the financial sector. A weak banking system is not only an extra strain on public finances, it also weakens aggregate demand and international competitiveness by underfunding private investment. The lower tax revenue and higher government spending resulting from the slowing economy then also put pressure on public finances.

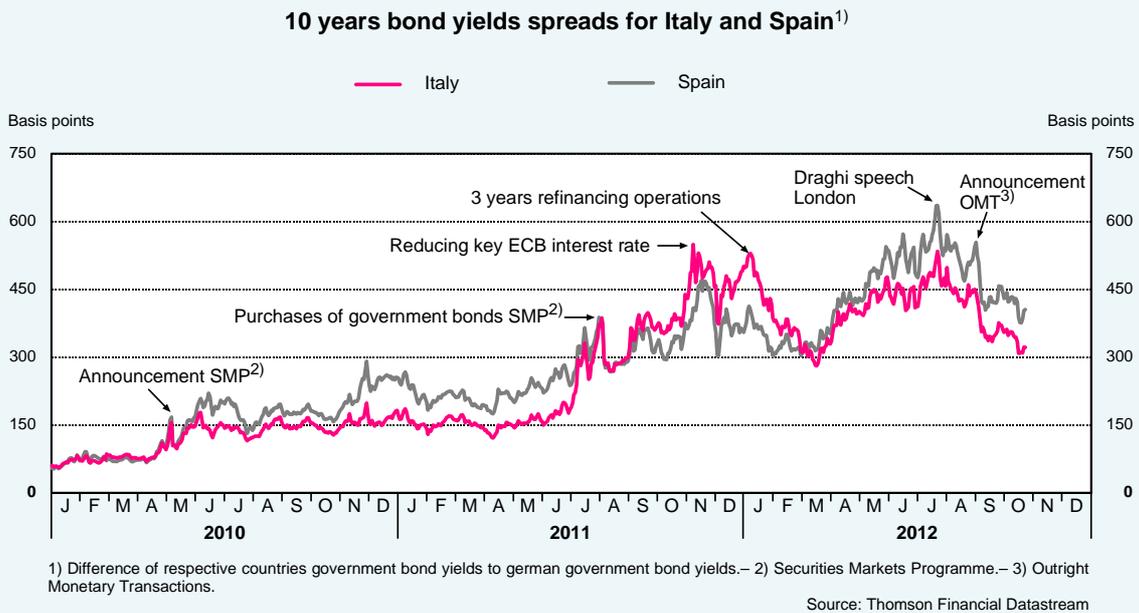


1. Sovereign debt crisis: Debt levels continue to rise

108. The **wave of mistrust** in the euro area was triggered by the dramatic development of public finances in Greece in spring 2010. Soon afterwards the markets also judged the fiscal situation of Ireland and Portugal to be so negative that the two countries had to seek protection under the rescue shield of the European Financial Stability Facility (EFSF). In the second half of 2011 Italy and Spain then increasingly lost the markets' confidence. Apart from the rescue programme for Spain's banks, neither country needed EFSF support. But this owed much to the ECB, which repeatedly responded to steepening rises in the two countries' sovereign risk spreads by announcing and then executing stabilizing measures (Chart 21, page 4).

109. The fact that certain euro-area states have been subjected to the **force of market pressure** much more than, say, the United Kingdom or the United States is essentially due to a key singularity of EMU: each member state's debt is denominated in a currency that its own central bank cannot create in national autonomy (Annual Report 2011 section 144). This core feature of a monetary union is an important reason for a constellation that would otherwise be hard to understand: whereas in 2012 the United Kingdom, despite running a budget deficit of 8.2 % of nominal gross domestic product (GDP), was able to borrow in late October 2012 at a long-term interest rate of 1.8 %, Italy – with a budget deficit of just 2.7 % – had to pay a yield of 4.9 % (Box 6, page 4).

Chart 21



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110. In 2012, as in the preceding years, the crisis countries again implemented **drastic consolidation measures**. This was particularly the case in Greece, which, for the second year running, cut its cyclically adjusted budget deficit by nearly 4 percentage points. Spain (2.7 percentage points), Italy (2.2 percentage points) and Ireland (1.6 percentage points) likewise pursued a very restrictive fiscal policy. The cyclically adjusted primary balance (i.e. the net budget surplus excluding interest payments) has consequently improved markedly in all of these countries. It is much higher in Italy, at 4.7 %, than in all other advanced economies, and in Greece and Portugal, too, has already moved into positive territory.

It should be noted, however, that the calculation of cyclically adjusted figures involves determining current potential output, which is generally problematic. This difficulty is compounded by the fact that no one knows exactly by how much the level of potential output has fallen. In Spain, for example, the real estate boom led to a build-up of production capacities in the construction sector which have become obsolete now that the property price bubble has burst.

Box 6

Determinants of yield spreads in the euro area

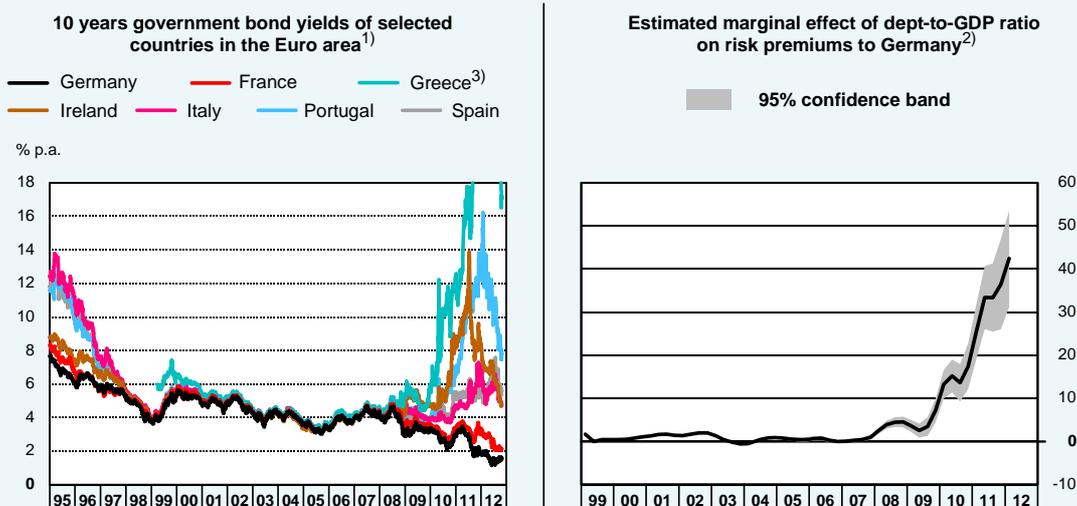
The disciplining effect of the financial markets is seen as a key condition for ensuring sound budgetary policies in the EMU. It is assumed that governments will be deterred from over-borrowing if a rising debt level translates automatically into rising risk spreads and thus rising borrowing costs. After the euro was launched, the yields of euro-area members' longer-term government bonds converged strongly (Chart 22, left). Until the crisis broke out, no member state with the exception of Greece had a yield spread over Germany of more than 25 basis points.

A number of empirical studies have been published in recent years that examine the determinants of these yield spreads before and after the start of the financial market crisis. These have

focused on the following factors: exchange rate risk, liquidity, general risk aversion of the markets and country-specific default risk, which is approximated using national fiscal variables, such as the debt-to-GDP ratio and public budget deficits. The empirical studies all show that the quantitative impact of the national budgetary position on the risk premia before the crisis was either very small or cannot be detected at all (Heinemann et al., 2012; von Hagen et al., 2011; Manganelli and Wolswijk, 2009).

Chart 22

10 years government bond yields and estimated marginal influence of debt-to-GDP ratio



1) Source: Thomson Financial Datastream.– 2) Estimates for the Euro area (excluding Luxembourg) according to the method of Bernoth and Erdogan (2012). An increase of the debt-to-GDP ratio by one percentage point effects an increase of risk premiums of x basis points. The estimation includes as further explanatory variables the difference of the expected budget deficit in Germany in the following year (OECD Economic Outlook) and a measure for the general risk aversion (yield spread of US corporation bonds with Baa rating to US government bonds).– 3) From 05.09.2011 to 12.10.2012 permanent over 18 % p.a.; figures inbetween not been given for enhanced legibility.

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Some more recent works concentrate on data after 2007 and try to identify which factors have contributed to the strong divergence of risk spreads among European states. Besides a general increase in risk aversion – above all, because of the financial market crisis – as well as additional country-specific risks due to a distressed banking system, these studies detect heightened market sensibility to states' budget positions as a major cause behind the greater differentiation of yield spreads. This shows up most clearly in an econometric model that estimates time-variable coefficients (Bernoth and Erdogan, 2012). Although in the early years of the EMU the difference in the debt level vis-à-vis Germany (and, to a lesser extent, differences in the deficit) was mirrored to some degree in the yield spreads, this effect diminished sharply up to 2007. But since mid-2007 this correlation has become stronger again and, as a slightly modified re-estimation of the model of Bernoth and Erdogan (2012) based on more recent data shows, has rocketed (Chart 22, right).

The quantitative differences are considerable. Thus whereas in 2010 a rise in the debt ratio of 1 percentage point pushed up the risk premium by an average of around 15 basis points, it widened to 40 basis points in mid-2012. Other recent findings on the evolution of yield spreads in the past few years confirm this picture (De Grauwe and Ji, 2012a). These findings show that particularly fiscally stressed countries have seen disproportionate rises in their risk premia when their fiscal data deteriorated. From a certain debt ratio upwards a country reaches "fiscal fatigue", meaning

that its ability to improve its primary balance can no longer keep up with its rising borrowing costs (Ghosh et al., 2011). Investors then regard the incentives for it to control its debt as being ineffectual and so curb their exposure.

Yet the sharp divergence of European risk premia in the past two years cannot be fully explained by fiscal fundamentals. Estimations performed by the International Monetary Fund for the first half of 2012 on the basis of macro and fiscal data show that the risk premia of Spain and Italy are some 200 basis points above the expected values (IMF, 2012). Other studies identify contagion effects between the crisis states (Metiu, 2012; Mink and de Haan, 2012) and come to the conclusion that a systemic risk exists within EMU.

Estimations carried out by the German Council of Economic Experts detect the newly priced-in risk that EMU could disintegrate as an additional cause for the unexplained portion of the risk premia (Table 13). In this estimation model government bond spreads over the ECB's deposit interest rate are compared with one day-lagged fundamentals (credit default swap (CDS) premia, yield spreads of US corporate bonds over US Treasuries as a measure of global risk aversion, bid-ask spreads as a measure of liquidity), the volatility of the yields (GARCH process) and market expectations of a country's exit from EMU (virtual share price on the Intrade prediction market). These estimations indicate that a significant part of the yield spreads are correlated with the risk of a euro area break-up (Klose and Weigert, 2012b). The rationale for this is that a positive (negative) coefficient of the variable for a given country's exit probability could be interpreted as a

Table 13

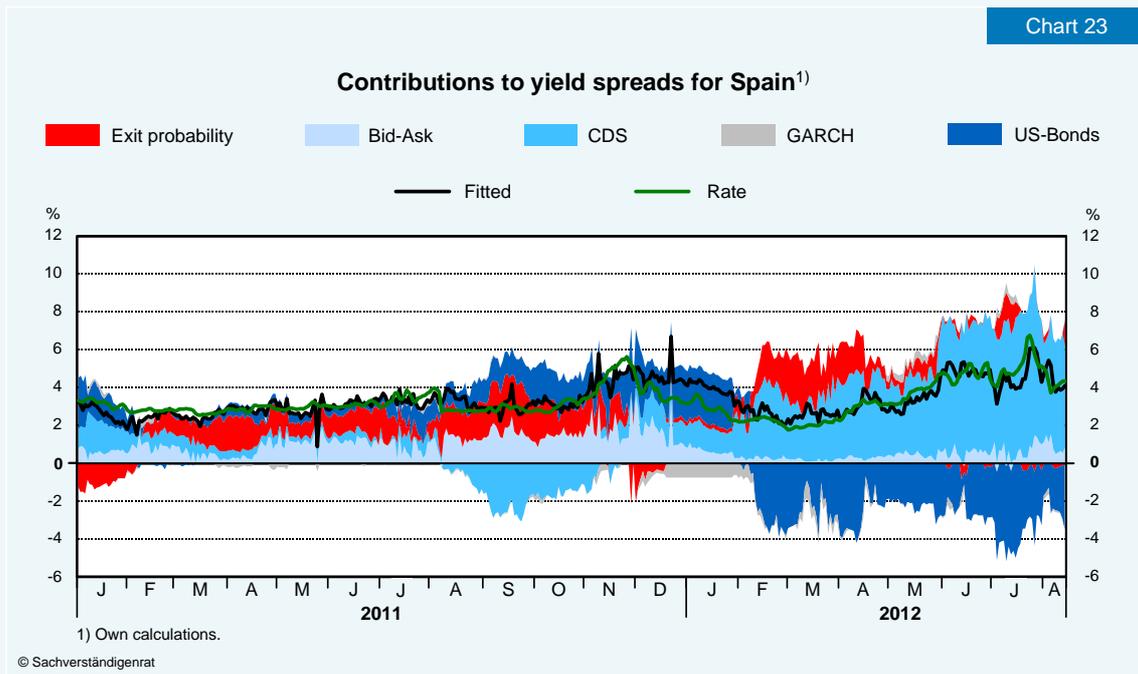
Estimates of yield spreads for Euro area countries¹⁾

	AT	BE	DE	ES	FR	IE	IT	NL	PT
Exit ²⁾	- 0,96 *** (0,10)	- 0,67 (0,46)	- 1,27 *** (0,13)	2,19 *** (0,61)	- 1,87 *** (0,01)	3,44 *** (0,05)	1,21 (0,75)	- 1,49 *** (0,08)	19,36 *** (1,84)
Bid-Ask	1,63 *** (0,08)	1,03 ** (0,51)	- 2,54 *** (0,06)	0,12 (0,15)	3,35 *** (0,01)	- 0,21 *** (0,01)	6,77 *** (2,61)	2,25 *** (0,28)	1,62 *** (0,39)
CDS	1,08 *** (0,05)	1,30 *** (0,08)	- 0,35 *** (0,06)	1,41 *** (0,07)	0,17 *** (0,00)	1,13 *** (0,00)	0,67 *** (0,09)	- 0,43 *** (0,09)	2,03 *** (0,04)
US-Bonds	- 0,09 (0,06)	1,17 *** (0,13)	0,55 *** (0,04)	1,47 *** (0,15)	0,74 *** (0,00)	1,37 *** (0,01)	2,83 *** (0,16)	0,57 *** (0,03)	- 5,89 *** (0,63)
GARCH	- 0,08 *** (0,01)	0,64 *** (0,06)	0,12 *** (0,02)	1,09 *** (0,08)	0,13 *** (0,00)	0,55 *** (0,00)	1,31 *** (0,10)	0,01 * (0,01)	- 0,11 (0,12)
Variance Equation³⁾									
Konstante	0,00 *** (0,00)	0,01 *** (0,00)	0,00 (0,00)	0,00 *** (0,00)	0,00 *** (0,00)	0,02 *** (0,00)	0,01 *** (0,00)	0,00 *** (0,00)	3,16 *** (0,72)
ARCH	0,32 *** (0,07)	0,31 *** (0,07)	0,54 *** (0,11)	0,22 *** (0,04)	1,58 *** (0,08)	1,23 *** (0,01)	0,30 *** (0,05)	1,00 *** (0,30)	1,00 *** (0,33)
TARCH	0,80 *** (0,26)	- 0,33 *** (0,07)	- 0,43 *** (0,10)	- 0,30 *** (0,04)	- 0,66 *** (0,06)	- 1,14 *** (0,01)	- 0,41 *** (0,05)	- 0,20 (0,35)	0,29 (0,55)
GARCH	0,45 *** (0,07)	0,79 *** (0,03)	0,77 *** (0,03)	0,92 *** (0,02)	0,26 *** (0,01)	0,47 *** (0,00)	0,87 *** (0,02)	0,13 * (0,08)	- 0,15 ** (0,07)

1) Own calculations, daily data. Dependent variable: Sovereign yields spreads minus ECB deposit rate. Estimation period 1/9/2011 to 14/08/2012; ***/**/* signal significance at the 99%/95%/90% level, standard error in brackets. AT-Austria, BE-Belgium, DE-Germany, ES-Spain, FR-France, IE-Ireland, IT-Italy, NL-Netherlands, PT-Portugal.- 2) Exit probability.- 3) ARCH-lagged residual squared terms of mean equation, TARCH-lagged residual squared terms of mean equation, given negative residual terms, GARCH-lagged term of variance equation.

yield mark-up (mark-down) that investors demand as a hedge against that country changing its currency. In the period from September 2011 to August 2012 the measure of the expected depreciation in the event of an exit is largest for Portugal, followed by Ireland, Spain and Italy, although the coefficient for Italy does not differ significantly from zero.

If, instead of fixed coefficients, variable coefficients are estimated throughout the period which are based on a rolling 100-day window, it can be seen how the contribution of the individual factors develops over time. In Spain's case, for instance, the default probability up to mid-2012 makes a substantial contribution, while CDS premia are more significant at the current end (Chart 23).



111. Despite the rigorous austerity programmes, none of the crisis countries has managed this year to prevent a further rise in its **debt ratio**. First, this is attributable to the fact that the perceptible economic slowdown has cancelled out a sizeable part of the envisaged retrenchment effect as tax revenue is lower than expected and additional government spending is required, notably due to rising unemployment. Second, government budgets are burdened by a growing debt service caused by climbing interest rates and rising debt ratios. This is why, overall, the reduction of the actual fiscal balance in all crisis countries remained well below the fall in the cyclically adjusted primary balance (Table 14, page 8). In addition to the resulting marked increase in government debt, the cyclical contraction of nominal GDP also had an adverse effect on the development of the debt ratios.

Owing to the bank recapitalization measures, the increase in Spain's debt ratio was especially large, surging from a relatively low 69.1 % in 2011 to 90.7 % in 2012. Greece still has the highest debt ratio of 170.7 % despite the sovereign haircut in March 2012. Although private investors waived more than 50 % of their nominal claims, the relief this gave the Greek state was fairly small, chiefly because it had to offset the associated losses of the Greek financial institutions, which were especially hard hit by the haircut.

As most of the crisis countries are likely to record sizeable budget deficits again in 2013 and nominal GDP growth will remain sluggish, their debt ratios will probably rise further. This will make them very vulnerable to confidence-related disruptions and swings of sentiment on the financial markets for the foreseeable future.

Table 14

**Cyclically adjusted primary balance, primary balance, the actual budget balance
and government debt problem of the five countries**
%

Country	2006	2007	2008	2009	2010	2011	2012
Cyclically adjusted primary balance¹⁾							
Greece	- 3,7	- 5,4	- 8,3	-13,1	- 6,1	- 1,5	0,9
Ireland	- 3,5	- 7,0	-10,7	- 9,2	- 6,3	- 4,6	- 2,3
Italy	- 0,0	1,7	1,7	1,2	1,0	1,8	4,7
Portugal	- 1,3	- 1,4	- 1,5	- 6,7	- 6,9	0,1	1,0
Spain	2,1	1,4	- 4,2	- 8,5	- 6,2	- 5,4	- 2,2
Primary balance²⁾							
Greece	- 1,3	- 2,0	- 4,8	-10,4	- 4,7	- 2,2	- 1,7
Ireland	3,9	1,0	- 6,2	-12,1	-27,9	- 9,6	- 4,4
Italy	1,0	3,1	2,2	- 1,0	- 0,3	0,8	2,6
Portugal	- 1,3	- 0,6	- 1,0	- 7,5	- 7,1	- 0,6	- 0,7
Spain	3,3	3,0	- 3,1	- 9,9	- 7,9	- 7,0	- 4,5
General Government Balance²⁾							
Greece	- 6,0	- 6,8	- 9,9	-15,6	-10,5	- 9,1	- 7,5
Ireland	2,9	0,1	- 7,3	-13,9	-30,9	-12,8	- 8,3
Italy	- 3,4	- 1,6	- 2,7	- 5,4	- 4,5	- 3,8	- 2,7
Portugal	- 3,8	- 3,2	- 3,7	-10,2	- 9,8	- 4,2	- 5,0
Spain	2,0	1,9	- 4,2	-11,2	- 9,4	- 8,9	- 7,0
Gross Debt²⁾							
Greece	107,3	107,4	112,6	129,0	144,5	165,4	170,7
Ireland	24,8	25,0	44,5	64,9	92,2	106,5	117,7
Italy	106,1	103,1	105,7	116,0	118,6	120,1	126,3
Portugal	63,7	68,3	71,6	83,1	93,3	107,8	119,1
Spain	39,7	36,3	40,2	53,9	61,3	69,1	90,7

1) Fiscal balance minus interest expense, adjusted for cyclical components in relation to production potential.– 2) In relation to nominal GDP.

Source: IMF

2. Macroeconomic crisis: Between light and shade

112. The countries of southern Europe have been struggling for quite a while with substantial **deficits in their international competitiveness**. This requires measures aimed at lifting their economies onto a higher long-term growth path. However, the adjustment processes triggered by the already implemented reforms will be accompanied in the short run by **negative economic developments** resulting from falling domestic demand owing to fiscal consolidation, the deleveraging of private debt and restrictive lending by banks. Moreover, structural reforms normally take some time to exert their positive effects on economic development, and they may temporarily even intensify crises (Barkbu et al., 2012). Conversely, the economic slowdown will depress the long-term growth outlook in the crisis countries if investment re-

mains weak and skilled workers emigrate because employment prospects are unfavourable in their own country.

113. In 2012 an **unexpectedly steep slump** occurred in the crisis countries. In September 2011 the International Monetary Fund (IMF) had forecast positive economic growth in Italy and Spain in 2012, and a decline of around 2 % for Portugal and Greece. The latest estimated growth rates for 2012 are now up to 4 percentage points lower. In a recent study the IMF showed that these forecast errors can be largely explained by a systematic underestimation of the fiscal multipliers during the crisis (Blanchard and Leigh, 2012). This underscores just how difficult it is to estimate the impact of austerity programmes and structural reforms ex ante. Apart from Ireland, all the crisis countries are in a clear recession, and Greece has slid into a deep depression. In view of the ongoing restrictive fiscal policy stance, none of these countries apart from Ireland can expect a change for the better in 2013 (section 76).

Besides these five crisis countries, other euro-area member states are also facing a marked economic slowdown. Thus Belgium, Finland, Slovenia and Cyprus recorded a drop in GDP in the second quarter of 2012 compared with the first quarter. The French economy has been stagnating since autumn 2011.

114. The weak economic development that has persisted in the euro area for some years now has led to a steep **increase in unemployment**. In September 2012 the average unemployment rate in the euro area reached 11.6 %, which was the highest level since the time series began in 1993 (Table 15). Greece and Spain have been particularly badly affected, with a jobless rate of over 25 %. In both countries youth unemployment is now well above 50 %, although this does not mean that every second young person who is looking for work cannot find a job (section 525). In all five crisis countries youth unemployment is above the 30 % mark.

Table 15

Unemployment in the crises countries

Country	Seasonally adjusted unemployment (%) ¹⁾			
	total		under 25 years	
	September 2011	September 2012	September 2011	September 2012
Greece ²⁾	17,8	25,1	44,4	55,6
Ireland	14,6	15,1	29,0	34,5
Italy	8,8	10,8	30,4	35,1
Portugal	13,1	15,7	31,4	35,1
Spain	22,4	25,8	47,8	54,2
As information:				
Euro area	10,3	11,6	21,0	23,3
United States	9,0	7,8	17,3	15,5

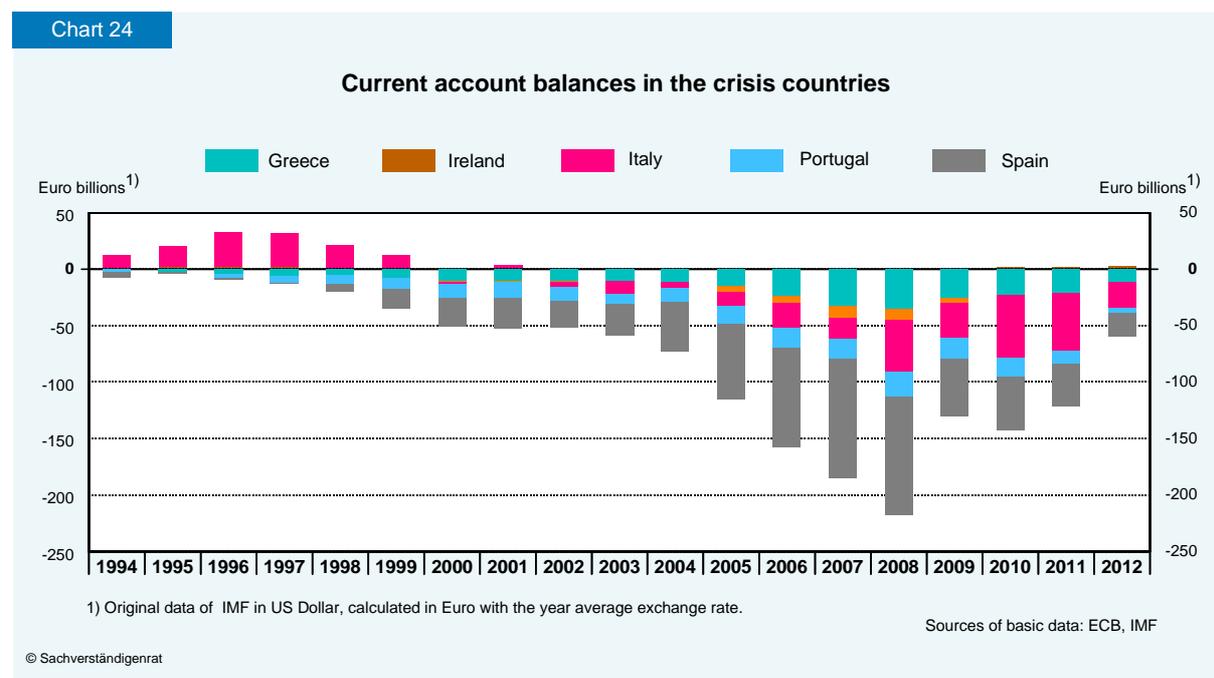
1) Of the EU standardized unemployment rates according to the guidelines of the International Labour Organisation (ILO Concept). Unemployed as a percentage of total civilian labor force.— 2) Status in each case July.

Source: EU

115. The extremely unfavourable economic outlook for the foreseeable future is a major hurdle to a rapid improvement of the situation in the other trouble spots. Without a return to a sustained growth path it will be extremely difficult to overcome the sovereign debt crisis. For the banking sector a continuing recession would mean further losses on loans to both firms and real estate investors. And without new investment it will be next to impossible for these countries to strengthen their competitiveness.

116. Over and above the current weak economic dynamics, the crisis countries have also been suffering for quite a while from **substantial deficits in their international competitiveness**. These are due in large part to the growth of their labour costs which, especially in the period from 2000 to 2008, clearly exceeded the increase in productivity and the average rate of inflation in the euro area. Compared to competitors outside of the euro area, the poor price competitiveness was additionally hampered by the euro's sharp appreciation against the US dollar up to 2008. A further complication was that – in contrast to Germany – these countries have a product profile that did not let them gain from the growing economic strength of China and the emerging markets in central and Eastern Europe. As the products which they manufacture directly compete with those coming from the emerging market economies, they actually suffered a negative trade shock (Chen et al., 2012).

117. These developments were reflected in **growing current account deficits** of the crisis countries up to 2008. In that year Greece posted a current account deficit of 14.9 % of nominal GDP, Portugal recorded a gap of 12.6 %. Spain's current account was "only" 9.6 % in the red, though in absolute terms it recorded the highest deficit of the crisis countries at 105 billion euro (Chart 24). With current account deficits of 5.7 % and 2.9 % respectively, Ireland and Italy performed comparatively well.

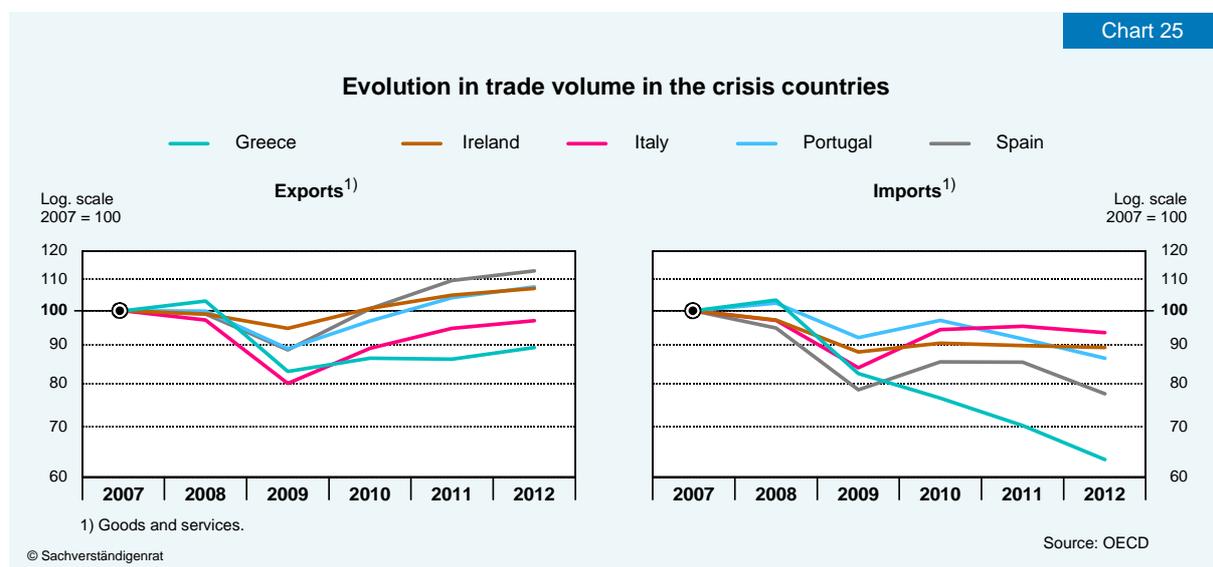


118. In view of these undesirable developments, it is an achievement that the current account balances in all crisis countries have improved distinctly in the past few years. In Portugal the

adjustment between 2008 and 2012 amounted to 10 percentage points of GDP, in Greece to 9 percentage points and in Spain and Ireland to around 8 percentage points. Given the extremely unfavourable starting position and rising interest payments to the rest of the world, Greece still has a current account deficit of almost 6 % of GDP. By contrast, Spain has cut its deficit to below 2 %, mainly due to a much improved trade balance. The Organisation for Economic Cooperation and Development (OECD) reports that Spain turned a shortfall of 63.7 billion euro in 2008 into a surplus of 23.3 billion euro in 2012.

119. While the reduction of the external imbalances is basically positive, it should be noted that much of this was due to the weakened domestic demand in these countries and hence not exclusively to improved domestic competitiveness. This applies especially to Greece, whose imports are around 37 % down on 2007, whereas its exports have shrunk by 11 %. Spain has fared better, now exporting 13 % more goods after price adjustment than before the crisis, while price-adjusted imports have contracted by a fifth. Ireland and Portugal rank in between. Both increased their exports by around 7 % in price-adjusted terms and simultaneously decreased their imports by one-tenth.

This shows that Ireland has improved its trade balance to roughly the same extent as Spain and Portugal. Ireland's advantage is that it started from a better position in 2007 than Greece, Portugal and Spain did. Italy's development is not directly comparable. It had a fairly small current account deficit of 2.9 % in 2008, but has failed since then to significantly narrow it further. On the contrary, its export volume has declined by around 3 % since 2007. This is due to Italian firms' poor price competitiveness (Chart 25).



120. The positive picture of external adjustment matches the crisis countries' attempt to boost their corporate competitiveness through comprehensive **structural reforms**. Assessing their success is hampered by the dual problem of evaluating the macroeconomic relevance of numerous microeconomic measures and gauging the extent to which they are actually being transposed into business practice. The OECD has therefore tried to develop an indicator for a country's reform efforts. In its study published in February 2012 it concludes that, among all

the OECD countries, Greece, Spain, Ireland and Portugal undertook the biggest reform efforts between 2008 and 2011 (OECD, 2012). Similar findings are contained in the World Bank's latest Doing Business Report, which looks at the regulation of SMEs. It confirms that the crisis countries, and particularly Greece, have made definite progress in this respect (World Bank, 2012).

121. The crisis countries have also made some advances in their **price competitiveness**. After many years of excessive pay rises, nominal wages in Greece have fallen by 14 % since 2009. In Ireland, where pay levels began to decrease in 2008, wages have been reduced by 6 %. In Portugal the wage trend declined slightly in 2012, but in Spain and Italy pay has continued to rise (Chart 26, top). The limited elasticity of wage growth to the crisis is due partly to the fact that rising unemployment has mainly eliminated low-skilled workers from the employment pool, so that the wage trend of the remaining employment pool shows an upward statistical bias.

Unit labour costs, which are a key measure of competitiveness as they capture productivity as well as nominal wages, have likewise decreased. Here again, Greece and Ireland lead the way, with Ireland slightly ahead owing to its greater productivity advance (Chart 26, middle). Spain also shows a positive trend in price competitiveness according to this indicator. However, the statistical measure of a country's productivity can increase automatically if unskilled workers are laid off.

Alternatively, cross-country price-level changes could be compared. However, the **GDP deflator** used for this is constrained by the fact that it contains indirect (consumption) taxes, which have been raised very sharply in the crisis countries in the past few years and so distort this indicator. This distortion cannot be satisfactorily factored out in the individual countries.

122. The remaining very high spread of unit labour costs over Germany might suggest that the crisis countries still need to lower wages substantially in order to regain their price competitiveness. But the comparison must extend beyond Germany to each country's main trading partners. A suitable measure for this is the **real exchange rate** based on unit labour costs. For this measure, unit labour costs in the economy as a whole or just in the manufacturing sector can be used. Most of the crisis countries show only a small adjustment need by this measure compared with the first half of 1999. Italy comes out worst by this indicator – as in the case of unit labour costs – as its real exchange rate based on unit labour costs in the manufacturing sector has appreciated by about 24 % compared with the first half of 1999 (Chart 26, bottom).

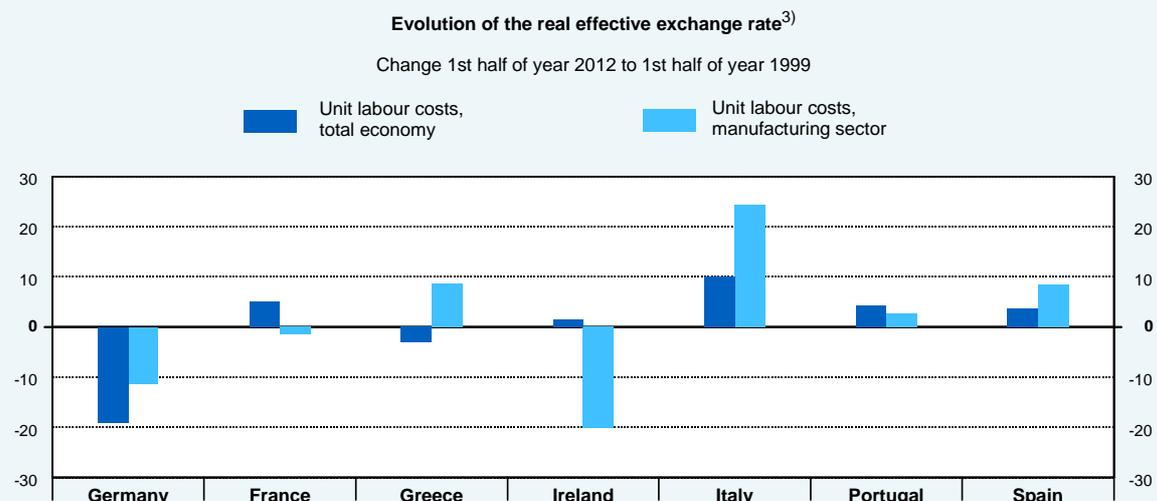
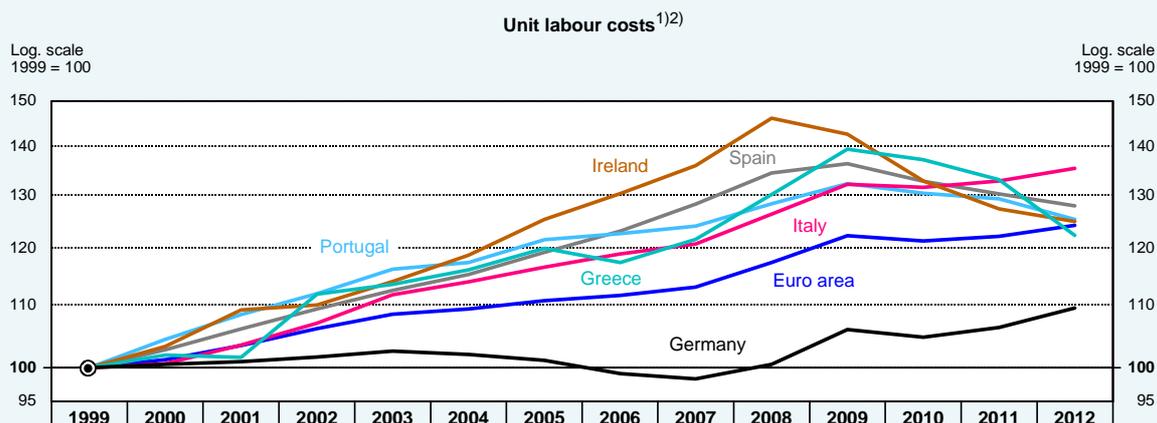
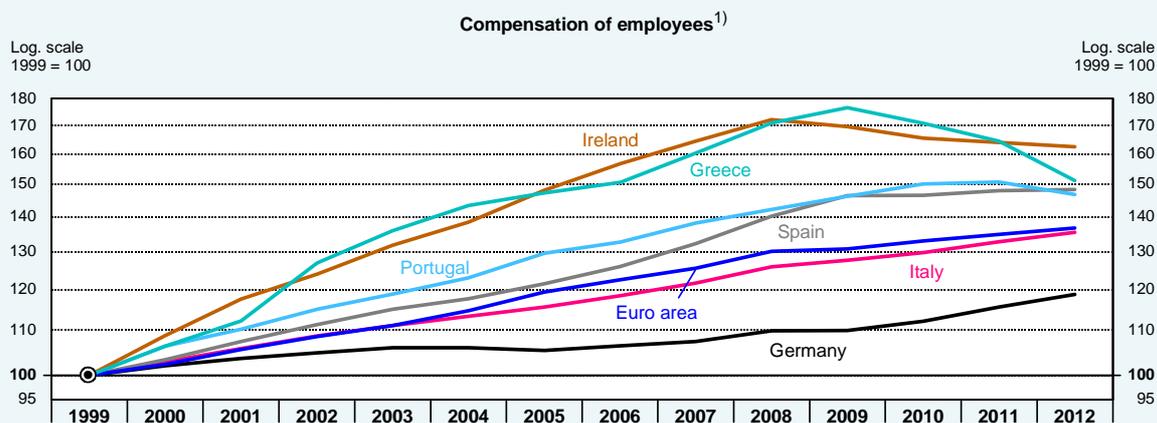
3. Banking crisis: Trust not yet restored

123. With large legacy risks on their balance sheets, a worsening economic setting, growing sovereign debt and speculation of a possible break-up of the monetary union, the fragile situation of the banks in the crisis countries has become even more unstable (section 257). The resulting lack of trust is the main cause of the contraction of cross-border financial relations

within the euro area. Interbank deposits have reversed dramatically in the past twelve months, especially in Greece, Italy and Portugal but to a lesser extent in Spain as well (Chart 27, right, page 14).

Chart 26

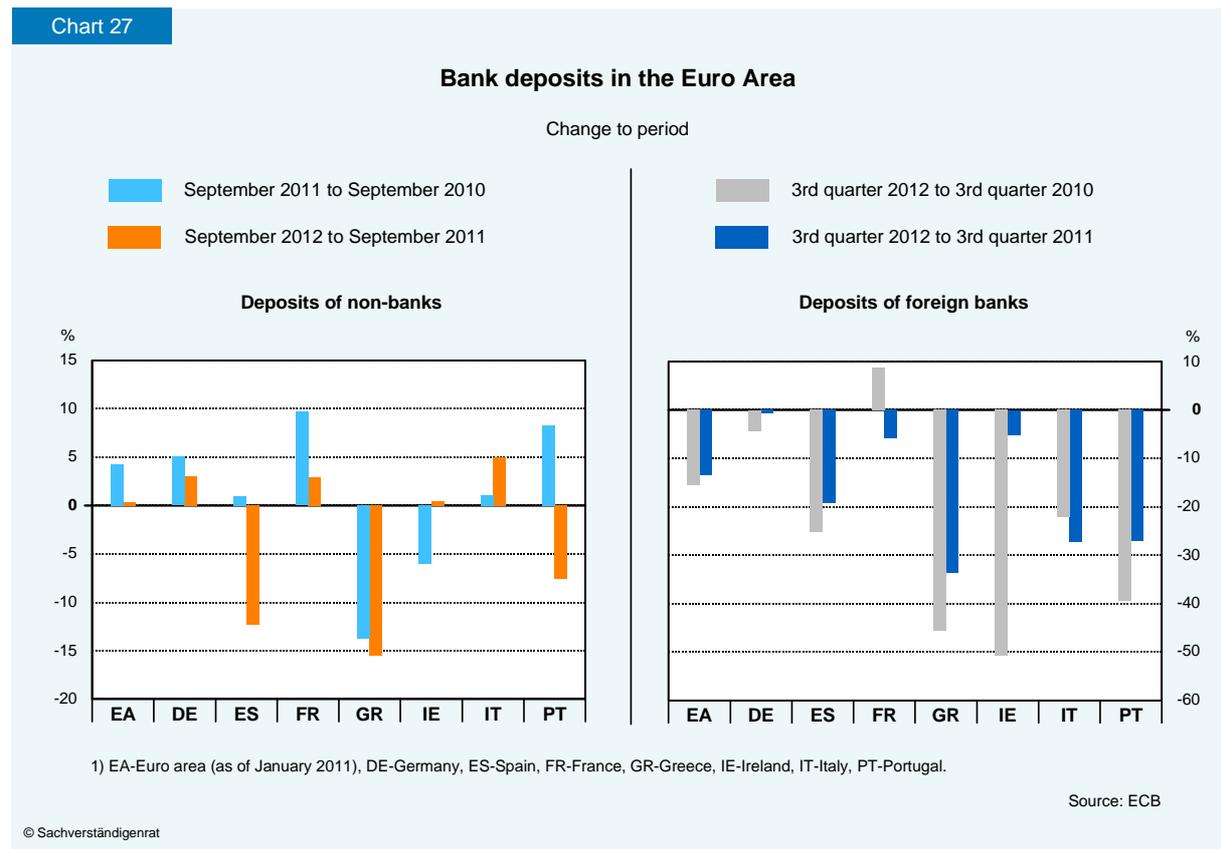
Indicators for the competitiveness of selected countries in the Euro area



1) Own calculations.– 2) Compensation of employees as a ratio of GDP per person in employment– 3) On basis of unit labour costs; for explanation see glossary of ECB monthly bulletin.

Sources: ECB, EU

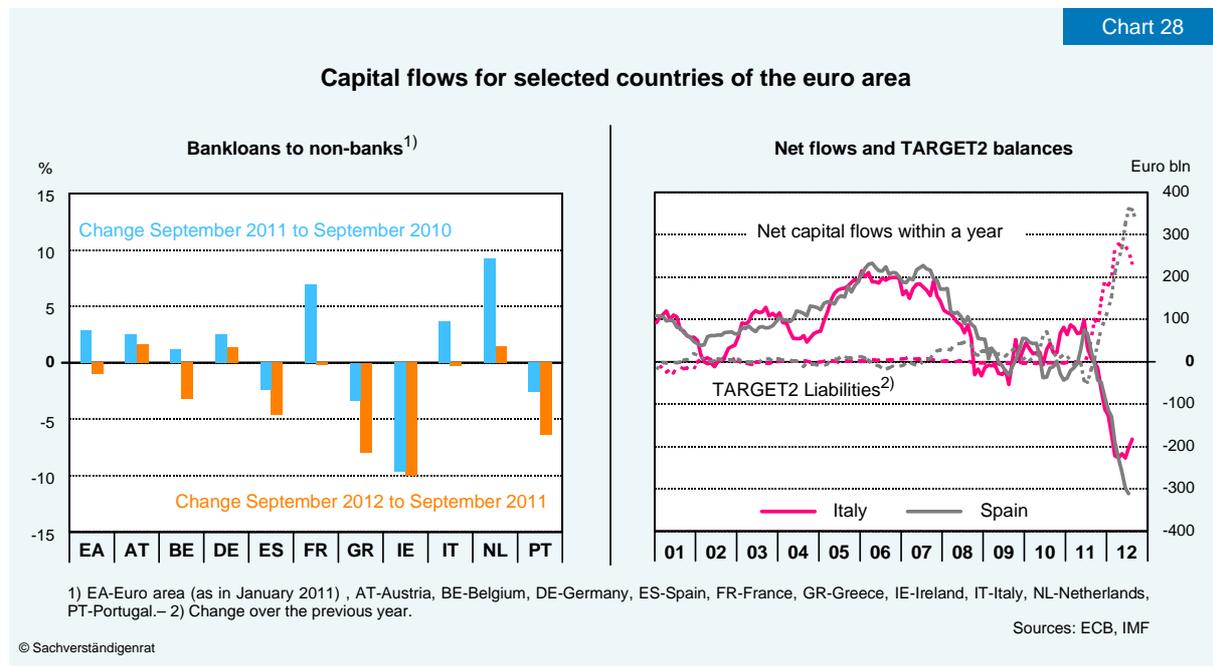
In some states firms and individuals, too, are becoming increasingly concerned about the safety of their bank deposits. These shrank significantly over the past year in Greece, Spain and Portugal (Chart 27, left). The vulnerable situation of crisis-country banks is also reflected in the still very high **credit default spreads** for these banks. While those narrowed considerably after the ECB's announcement of unlimited purchases of government bonds with a maturity up to three years, they are still above the peaks following the collapse of the investment bank Lehman Brothers. This means that credit risks of euro-area banks are now being perceived very differently by the market than those of financial institutions elsewhere.



124. Higher capital requirements, ongoing asset impairment, the worsening economic outlook plus falling credit demand are impacting increasingly negatively on **bank lending**. This was particularly evident over the past year and has hit Ireland and Greece especially hard, although banks in Portugal, Spain and Belgium have also deleveraged strongly (Chart 28, left). The crisis countries thus face a stressed financial setting which impairs their further economic development.

125. An additional indicator of the euro area's unstable financial system is the further jump in the **TARGET2 balances this year** (Sinn, 2012). Germany tops the list of creditor countries with around 700 billion euro of outstanding claims, followed by the Netherlands with 120 billion euro, Luxembourg with 110 billion euro and Finland with 70 billion euro. The biggest debtor nations in TARGET2 are Spain (420 billion euro), Italy (290 billion euro), Greece (110 billion euro), Ireland (100 billion euro) and Portugal (70 billion euro). This is equivalent to 30 % of Spain's GDP and 11 % of Italy's output. Given that Spain's current ac-

count deficit is down to 2.0 % and Italy's to 1.5 %, it is clear that the TARGET2 balances are due almost completely to capital flows. This is illustrated by the pattern of these two countries' net capital outflows and TARGET2 balances (Chart 28, right).



126. To the extent that TARGET2 balances merely represent a substitution of cross-border claims on banks and the government sector in crisis countries, Germany's rising claims do not mean a higher liability risk (De Grauwe and Ji, 2012b). But this interpretation does not tell the whole story, since a huge restructuring of existing claims and the associated risks is occurring, which entails dangerous redistribution effects (Sinn and Wollmershäuser, 2011). While German banks and non-banks have reduced their exposures to the crisis countries via the TARGET2 mechanism, the Deutsche Bundesbank's claims have increased (Box 7).

Box 8

Link between ECB funding and the TARGET2 balances

The country-specific balances within the euro area's gross settlement system TARGET2 began to surge with the outbreak of the financial crisis and have swollen further in 2012 (Chart 29, right).

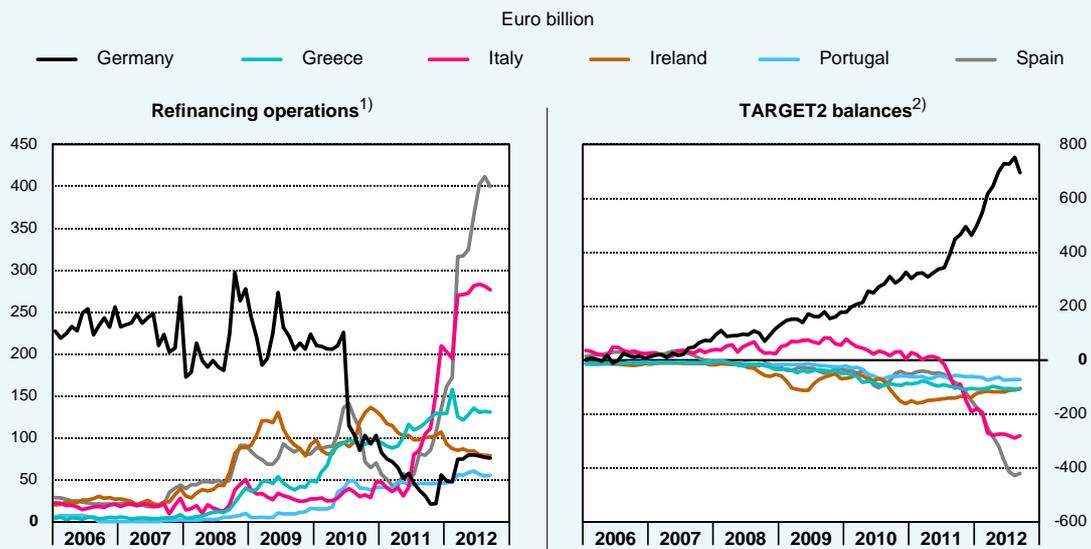
Whereas the liabilities of Greece and Portugal have remained flat in 2012 and those of Ireland have clearly decreased, those of Spain and Italy have increased further. This is directly linked to the ECB's two three-year refinancing operations, of which banks from these two countries have made above-average use in the provision of liquidity (Chart 29, left). But banks from other countries have also tapped this source of central bank liquidity although to a lesser extent.

These further diverging balances raise the question of what alternatives are available. One suggestion is to adopt the US Fedwire system in the euro area the settlement mechanism (Sinn and Wollmershäuser, 2011). In this system a zero balance is automatically restored through an an-

nual transfer of assets among the individual Fed district banks. It turns out on closer inspection, however, that this settlement mechanism is just an ex post accounting system and is therefore not suited to curbing the balances a priori (Klose and Weigert, 2012a). And in the current situation, in which emergency liquidity assistance (ELA) from some national central banks (section 141) represents an important refinancing channel, the Fedwire system is not directly transferable to all central banks in the euro area. This is due to the fact that, unlike in the United States, claims are not backed by marketable assets on account of ELA.

Chart 29

Refinancing operations and TARGET2 balances of selected central banks in the Euro area



1) Claims against MFIs in the Euro area from political monetary operations.– 2) Trans-European Automated Real-time Gross settlement Express Transfer system.

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Sources: National central banks

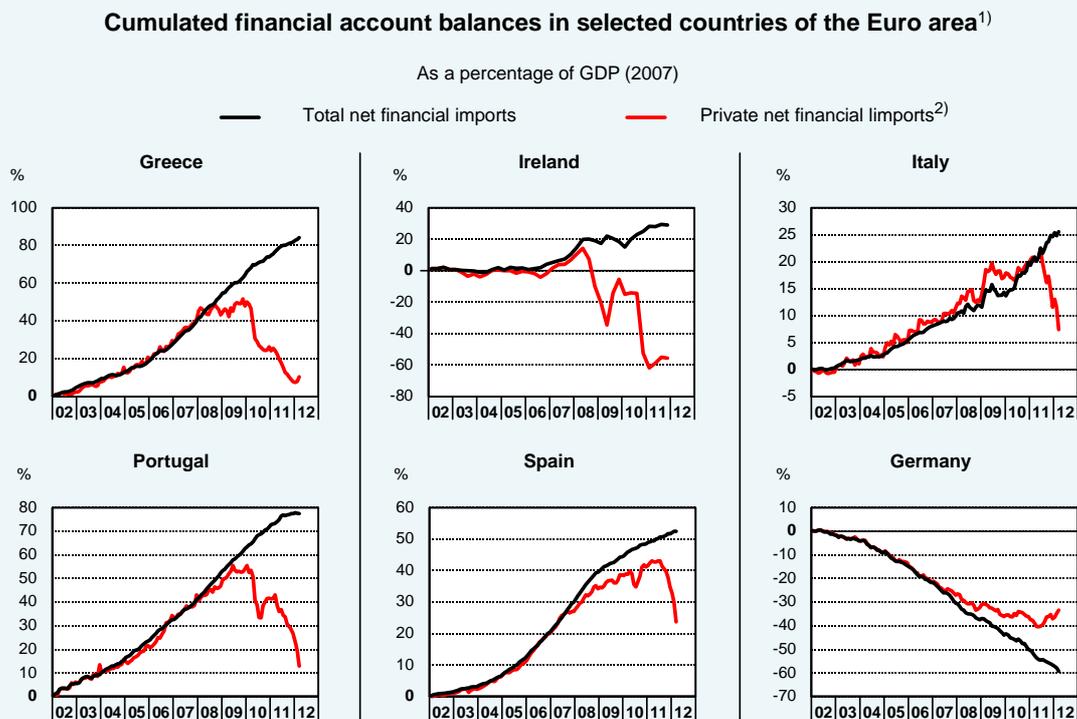
Limiting the TARGET2 balances by capping the refinancing line of a euro-area member state's banking system would likewise be no solution as, in the worst case, bank transfers between member states would have to be stopped. That would not only contravene the principle of the free movement of capital within a monetary area, it would also spell the end of the euro.

Whether in the current situation, **sudden stops** would have occurred in the absence of the payment settlement mechanism for the entire euro area, meaning a sudden and massive reversal of a country's international capital flows, can be tested empirically using the Calvo criterion. This stipulates that a sudden stop is present if the annual change in private capital flows falls below the long-run mean by two standard deviations. A sudden-stop phase must satisfy the criterion of the double standard deviation at least once, whereas the immediately preceding and following periods only have to show a single standard deviation. Thus defined, a sudden-stop phase must persist for at least three months.

For this analysis the inflows in the capital accounts of the individual euro-area states are decomposed into private and public flows (Merler and Pisani-Ferry, 2012). Payment flows relating to rescue measures are subtracted from, and TARGET2 balances added, to the cumulated net capital imports. ECB bond purchases under Securities Markets Programme (SMP) cannot be deducted as their break-down by country has not been published. These bonds are therefore attributed to private capital inflows and thus lead to an over-estimation of actual private flows. The

result of the analysis clearly shows that in the euro-area crisis countries private flows are being increasingly substituted by public flows, comprising assistance packages and TARGET2 funding, whereas in Germany private net capital exports were smaller than total net capital exports (Chart 30). Application of the Calvo criterion is confined to private capital flows as only these provide insights into whether a sudden stop would have occurred without public financing.

Chart 30



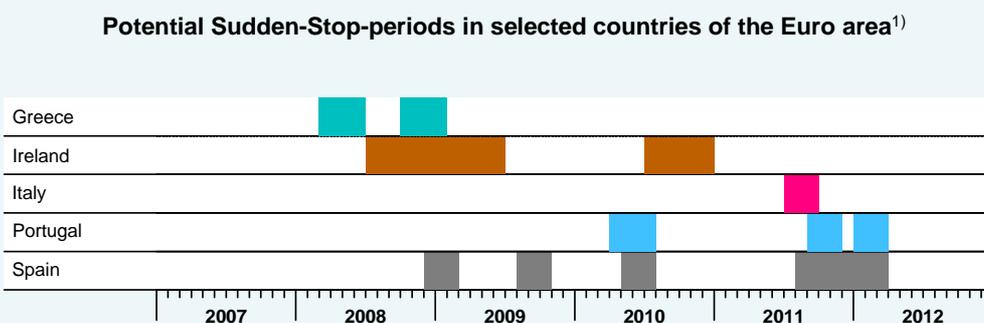
1) Own calculations; positive values = net financial imports.— 2) Plus TARGET2 balances and minus support packages to save the Euro.

Source of basic data: Thomson Financial Datastream

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It can be seen that Greece would have been hit by a sudden stop already in 2008 and 2009, like Ireland and Spain, whereas Portugal and Italy would have experienced one only in 2010 and 2011 (Chart 31). It follows that the European government rescue programmes have cushioned the painful process of rapidly adjusting current account balances which would have occurred if the distressed states had been wholly reliant on private capital market refinancing.

Chart 31



1) Coloured areas mark the period for potential Sudden-Stop-periods.

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II. The ECB's difficult dilemma

127. The constant escalation of the debt crisis from spring 2010 placed the ECB in a very difficult dilemma. While policymakers tried to put in place a rescue mechanism for distressed states in the form of the EFSF and then the European Stability Mechanism (ESM), its fire-power was and still is too small to effectively shield big nations like Spain and Italy – with a combined sovereign debt of some three trillion euro – against the vicious circle of weakening investor confidence and rising bond yields. As investors were well aware of this, the risk spreads for these two countries' bonds repeatedly surged in the past couple of years, and these spiralling spreads could only be halted and reversed by substantial central bank interventions.

The ECB's non-standard monetary policy measures not only contributed to stabilizing the capital markets. By expanding the volume and extending the maturity of its refinancing operations in a situation of growing mistrust in the soundness of the financial systems in the crisis countries, the ECB also ensured that the banks could continuously obtain sufficient refinancing. They have come under pressure on several fronts in the past few years (section 256 f.):

- In some countries, banks' balance sheets are still impaired by the fall-out from the real estate crisis.
- They have had to substantially write down their holdings of government bonds.
- The economic slowdown is additionally straining their loan portfolios.
- Speculation of a possible break-up of EMU has triggered outflows of deposits by both domestic and foreign savers.

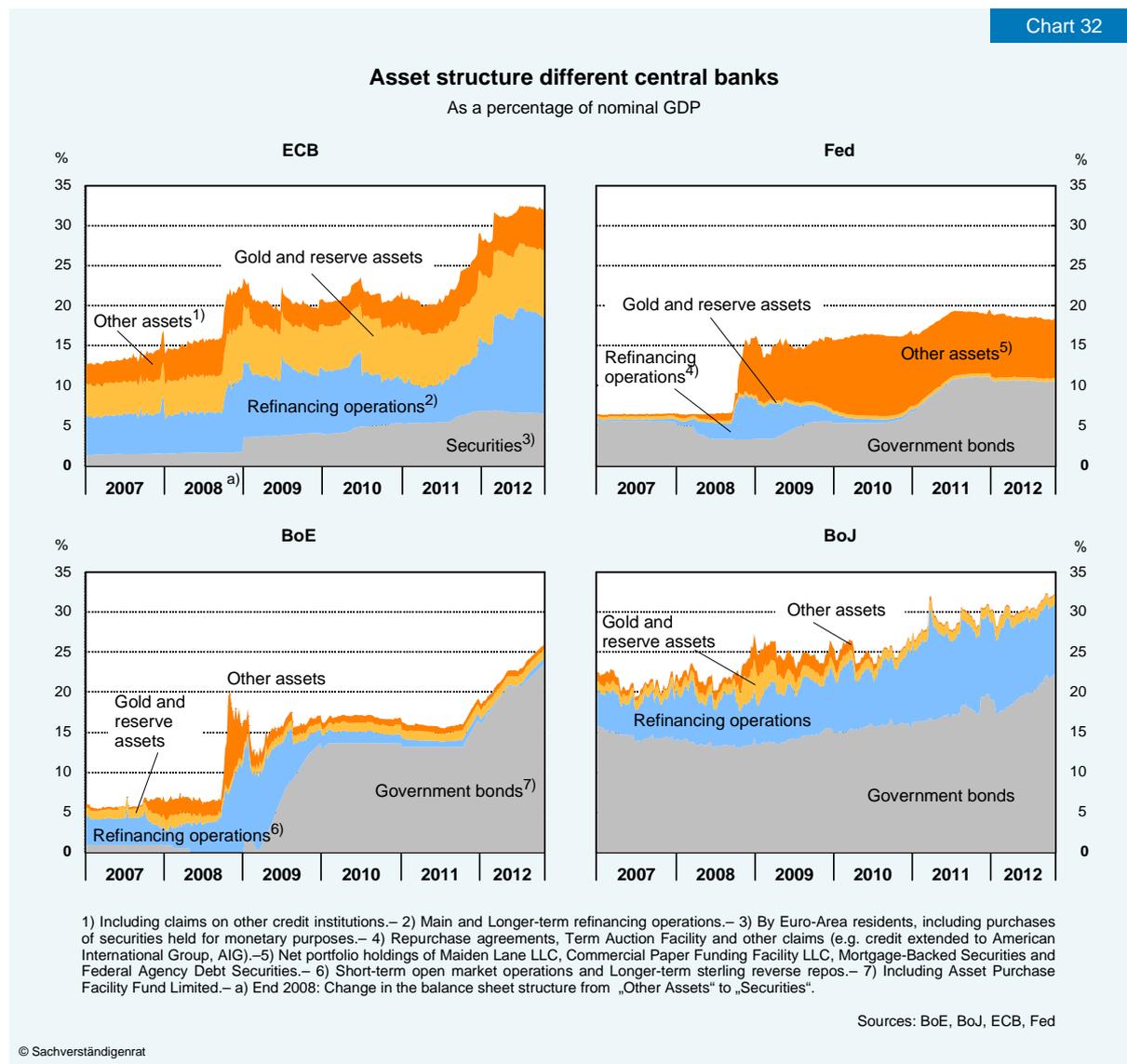
1. Supporting the capital markets

128. The growing recourse to ECB funding has expanded its balance sheet substantially. But this is not unique to the euro area, as the **total assets of central banks** have also exploded elsewhere since the collapse of Lehman Brothers in September 2008. The Bank of England (BoE) leads the field, with an increase in relation to nominal GDP by 310 % since the start of 2007, followed by the US Fed with 180 % and the ECB with a score of 150 %. The sole exception is the Bank of Japan (BoJ), which has expanded its balance sheet only moderately over the past few years (Chart 32).

The key difference is that the balance sheet expansion of the Fed and the BoE, known as **Quantitative Easing**, mainly involved buying additional government bonds and, in the Fed's case, private bonds as well (Chart 33, left, page 20). The Eurosystem, by contrast, has expanded its balance sheet mainly by granting refinancing credit to banks. In the USA and the UK this item can almost be neglected, since the bond purchases have created excess reserves in the banking system.

The ECB's bond purchases to date have occurred on a more moderate scale. While the bond purchases of the BoE and the Fed so far amount respectively to 24 % and 16 % of GDP, the corresponding ratio for the ECB is 7 %. The BoJ, which bought large quantities of govern-

ment bonds in the first half of the last decade, has bond holdings amounting to around 22 % of GDP (Chart 33, right, page 20).

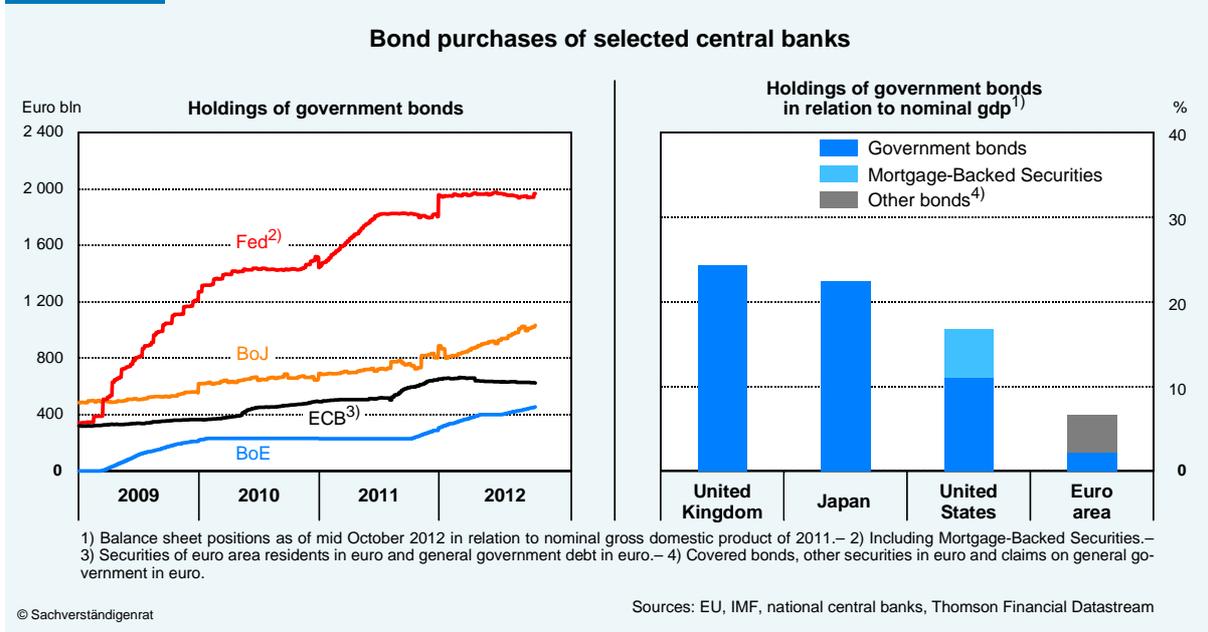


129. So far the ECB has bought bonds on the open market in three programmes. It launched two **Covered Bond Purchase Programmes (CBPP)**, buying the amount of 60 billion euro between July 2009 and June 2010 and securities worth another 16 billion euro from November 2011 to October 2012. Then it launched its **Securities Markets Programme (SMP)** in May 2010, buying government bonds of the crisis countries on the secondary market worth 209 billion euro. The ECB has not disclosed the precise breakdown of its bond purchases by country and maturity. The SMP was suspended following the two three-year longer-term refinancing operations (LTROs) and was discontinued after the OMT were introduced.

130. The massive bond purchases by the BoE and the Fed must be seen in the context of an exceptionally steep **rise in government debt** in the two countries. The United Kingdom's debt ratio increased by 45 percentage points between 2007 and 2012 and that of the United States by 40 percentage points. The euro area's debt-to-GDP ratio has risen at the slower rate of around 27 percentage points. The massive interventions by the Fed and the BoE in the

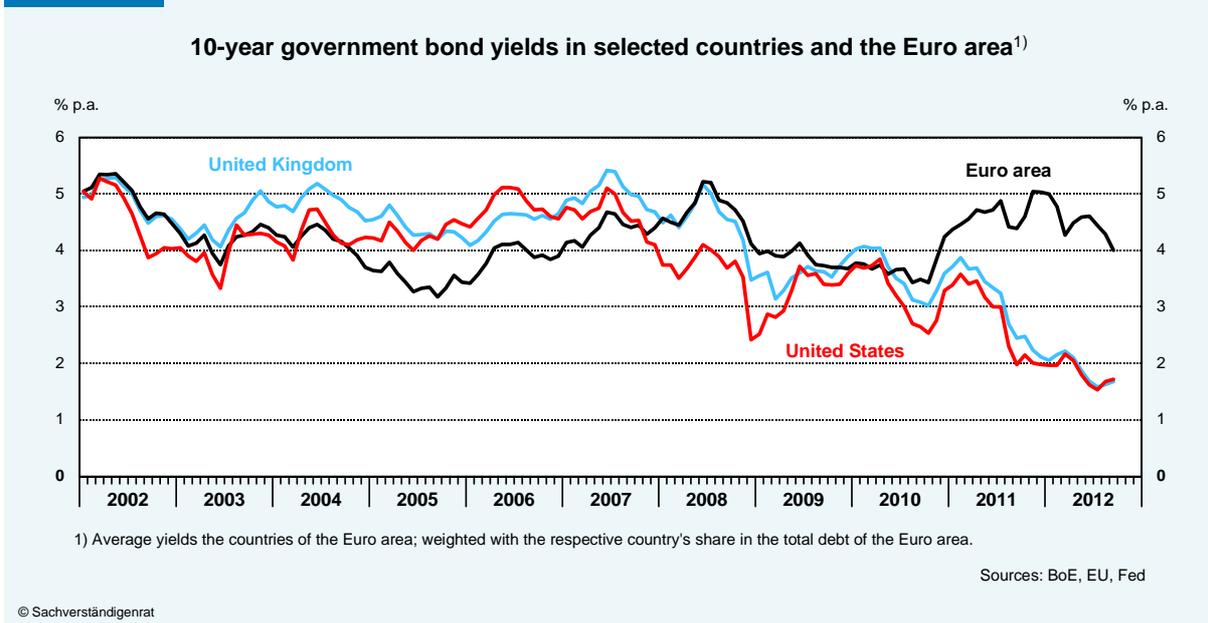
bond market enabled their countries' steeply rising sovereign debt to be financed at historically low long-term interest rates – which contradicts the traditional crowding-out theory. This **financial repression** boils down to a covert channelling of funds from the holders of government bonds to the state.

Chart 33



131. The different approaches taken by the ECB, on the one hand, and by the Fed and the BoE, on the other hand, are likely to have contributed to the considerable divergence in their respective **bond yields**. While the average bond yield in the euro area (weighted by the member states' proportional share of total euro-area government debt) and those of the United States and the United Kingdom were on a similar level up to the outbreak of the financial crisis, they have drifted far apart in the past two years (Chart 34).

Chart 34



132. Studies of the respective easing policies concerning the US Fed (Krishnamurthy and Vissing-Jorgensen, 2011; Gagnon et al., 2011) and the BoE (Joyce et al., 2011) confirm that **Quantitative Easing** measures are capable of lowering interest rates and thus of stimulating the real economy even after interest rates have reached the zero floor. They show that even the announcement of the respective programmes by the US and UK central banks pushed long-term interest rates down by up to 100 basis points. Similar studies find that the ECB's expansion of its refinancing operations since full allotment is reintroduced lowered longer-term interest rates by more than 100 basis points, though the policy announcements had only a small impact in this case (Abbassi and Linzert, 2011). It is also evident, however, that the effectiveness of quantitative easing diminishes over time (Ehlers and Sushko, 2012).

133. Given the ECB's comparatively restrained interventions in the capital market hitherto, its announcement on 6 September 2012 of the Outright Monetary Transactions (**OMT**), with no ex ante quantitative limit, represents a **strategic realignment**. Like the SMP, the OMT is a programme that lets the ECB buy government bonds of euro-area crisis countries on the secondary market. Unlike the SMP – under which bond purchases were not subject to conditionality – the purchase under OMT is coupled to an application and the adherence to a programme under the EFSF or the ESM by the country concerned (Table 16). This programme can be executed either in the form of a full **macroeconomic adjustment programme** or as a precautionary programme (Enhanced Conditions Credit Line), with a mandatory possibility of primary market purchases by the EFSF or the ESM.

Table 16

**Comparison between Securities Markets Programme (SMP) and
Outright Monetary Transactions (OMT)**

	SMP	OMT
Conditionality	Non	Strictly and effectively attached to an appropriate ESM programme (full or precautionary programme), the IMF shall be involved
Reversibility	Holding until maturity	Yes, if there is no longer a necessity by money political reason or if countries do not comply with the programme conditionality
Explicit interest limit	No	No
Seniority	Yes	No
Maturities of purchased bonds	Undisclosed	Short term (maturities of between 1 and 3 years)
Transparency	Volumes weekly published	Volumes weekly published, countries and average maturity monthly
Sterilisation	Yes	Yes

However, this is only a necessary but not a sufficient condition for ECB support. Conversely, the OMT can be terminated immediately if a country no longer complies with the programme conditionality. In contrast to the SMP, the OMT are focused on purchases of short-dated bonds with a maturity of one to three years. OMT are also more transparent, since besides the

weekly volume (which, as in the case of the SMP, will be sterilized via quick tenders), the average duration of OMT holdings and their breakdown by country will be published on a monthly basis. (ECB, 2012). A new feature of the OMT is that the ECB has waived its seniority status. This means any OMT bond purchases will entail a much bigger loss risk for the ECB and a smaller risk for private investors.

134. The ECB aims at pegging its OMT transactions to the **conditionality of the euro rescue shields** in order to counteract possible moral hazard at the level of national economic policy. But in doing so it has made itself more dependent on the political decision-makers. Assuming it abides by the terms of its announcement, the ECB can only buy government bonds under the OMT after the country in question has made a successful application to the ESM, and it must cease its purchases if the state fails to comply with the conditionality laid down in the programmes (Box 8). It cannot be ruled out that this could encourage policy-makers to benignly attest a country's compliance with the programme so as to keep the ECB's support flowing. The blurring of the boundary between monetary policy and fiscal policy that this implies is very dangerous and can at most be considered an emergency solution but certainly not a permanent stabilization mechanism. From a regulatory point of view, it is thus crucial to free monetary policy from this function. The European Debt Redemption Pact proposed by the German Council of Economic Experts is an alternative plan under which joint liability would not be permanent and unlimited but temporary and limited, and would be additionally ensure sound fiscal policies by a set of different safeguards.

Box 8

The ECB's Outright Monetary Transactions (OMT)

In view of the sharply rising instability in the euro area up to the end of July 2012, the ECB felt obliged to send a clear signal to the markets by announcing its readiness to buy unlimited amounts of government bonds ("Outright Monetary Transactions" – OMT). So far this policy has been successful as market nervousness immediately dropped without the ECB actually having to intervene in the bond market.

The ECB's justification for launching OMT was that they would "enable the Eurosystem to address severe **distortions** in government bond markets which originate, in particular, from unfounded fears on the part of investors of the reversibility of the euro" (ECB, 2012). As sovereign bond yields have a major influence on banks' funding costs, this leads to divergent developments in the interest rates paid by borrowers in the individual member states (Chart 35). This disrupts the transmission process of the single monetary policy. If escalating stress had led to a steep slump in the real sector, this would additionally have triggered deflationary impulses.

Buying and selling bonds in **open market operations** is a standard tool used by central banks. They can do this either through securities repurchase operations (repos), in which the purchase (sale) of a bond is coupled to its later resale (repurchase) at fixed terms, or through outright sales or purchases.

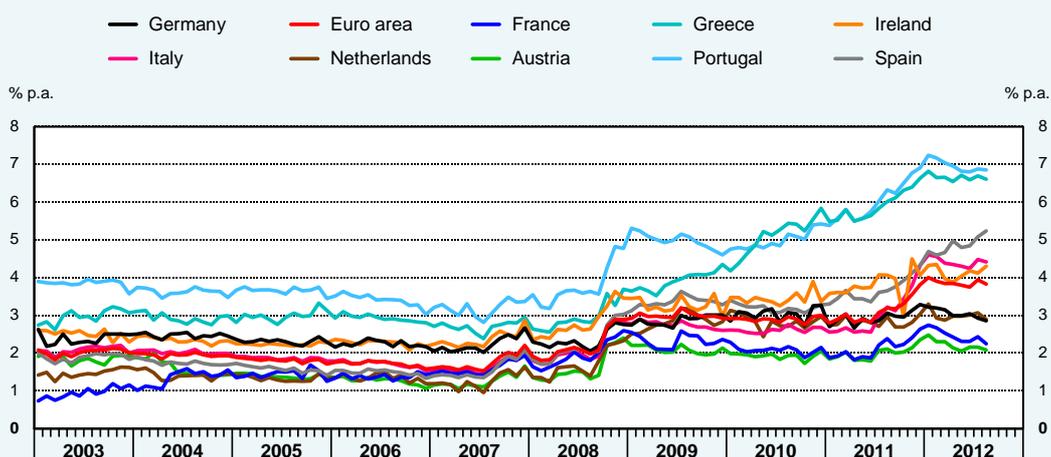
Central banks typically use one of these two forms of open market operations to ensure the **on-going funding of the banking system**. Government bonds are the direct or indirect counterpart of the central bank money provided to the banks:

- In the United States the Fed buys US Treasuries from the banks directly and outright. Until the outbreak of the financial crisis its portfolio therefore almost wholly comprised US Treasuries.
- The ECB has opted to provide basic refinancing via loans to banks that have to be collateralized. Government bonds play a big role in these operations as collateral. The amount of sovereign bonds held by the ECB as collateral jumped from 230 billion euro in 2007 to 457 billion euro in the second quarter of 2012. Their share of the collateral pool came to 20.1 % and 18.6 % respectively.

In normal times central banks use government bond markets as a conduit for monetary policy. This directly or indirectly influences the state's financing conditions. This does not always automatically mean monetary financing of the state. It is hard to draw a clear line between monetary policy and monetary financing of the state, since a sharp distinction would require the central bank to accept only private bonds or gold as collateral instead of government paper.

Chart 35

Loans interest rates spreads in the Euro area: new loans to nonfinancial corporations¹⁾



1) Difference of respective countries MFI interest rates (new business) and EONIA: Loans up to EUR 1 million at floating rate and up to 1 year initial rate fixation (other than revolving loans and overdrafts, convenience and extended credit card debt).

Source: ECB

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Concerning the OMT – which are a designated crisis intervention tool – the ECB can primarily use its wide discretion to justify them as a response to **market distortions**. It is difficult for outsiders to judge whether that claim is justified. The euro crisis is indeed very protracted, and the vicious circle comprising the banking crisis, the sovereign debt crisis and the macroeconomic crisis has certainly led to considerable dislocations in both the real and the financial sector by severely unsettling investors, firms and consumers.

However, the ECB has tied deployment of the OMT to the requirement that a country must subject itself to a programme of the European Stability Mechanism (ESM) with **strict and effective conditionality**. One can understand the ECB's desire to combine the OMT with a high degree of fiscal discipline, which it would not be able to impose on a state itself. Yet the ECB's action drags it onto the borderline between intervention to restore market stability, and monetary financing of fiscal policies.

Whether the ECB actually crosses this red line will depend inter alia on the duration and intensity of its bond purchases. It would be easier to assess a constellation such as that in the UK, where the BoE has bought up around two-thirds of the country's fresh debt between 2008 and 2012 via its Quantitative Easing programme. But the unique nature of the euro crisis makes it extremely hard in economic terms to define thresholds for when OMT bond purchases turn into monetary financing of fiscal policies and for the maximum duration of a "market disruption".

This unclear situation highlights the pitfalls of attempting to solve the problem of a lack of confidence in government bonds primarily through monetary policy means. This is why the German Council of Economic Experts is proposing its model of a European Redemption Pact, which re-assigns responsibility for resolving the problem to the fiscal policy domain.

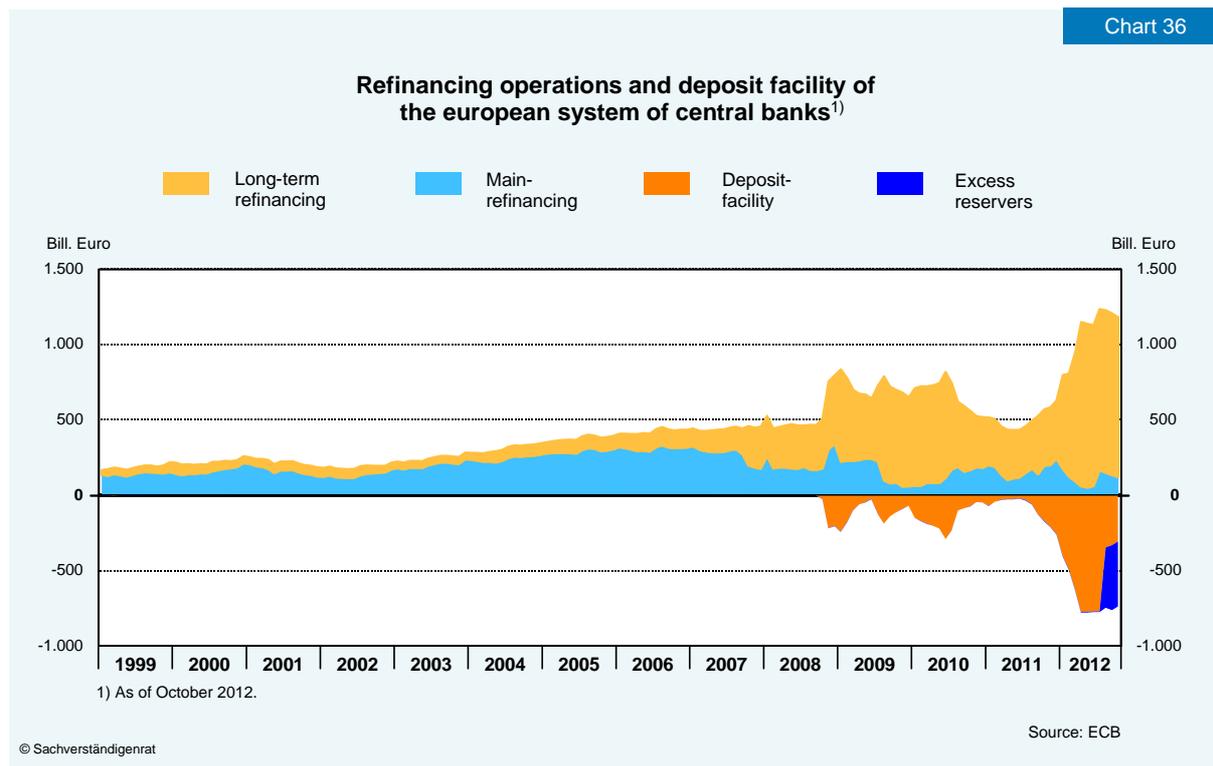
2. Stabilizing the banking system

135. Unlike the Fed and the BoE, the ECB has so far focused on stabilizing the banking system through its **non-standard monetary policy measures**. In view of the sharply worsening situation of many banks in the euro area, the ECB has taken some unusually extensive steps over the past twelve months.

- It has extended the maturity of its LTROs from one to three years.
- It has cut its minimum reserve ratio to 1 % after holding it for many years at 2 %.
- It has increasingly diluted its eligibility criteria for collateral useable in its refinancing operations.
- The volume of the Emergency Liquidity Assistance facility that can be granted by individual central banks, and which the ECB Governing Council can block with a two-thirds majority, has been increased further.

136. After the ECB had already reacted to the crisis by allotting all bids in full and extending the **maturity of its refinancing operations**, it decided in December 2011 to prolong the term of its LTROs to three years. These three-year LTROs, nicknamed "**Big Bertha**", were executed in late December 2011 and February 2012. The banks received an injection of liquidity totalling more than one trillion euro. By introducing such an exceptionally long maturity for a refinancing operation, the ECB has effectively taken over the role of maturity transformation from the banks. The interest rate risk remains with the banks, however, since the interest rate to be charged for the three-year operations is geared to the average interest rate for the ECB's main refinancing operations over the life of the operation.

However, the quantitative dimension of these three-year LTROs is not given by their absolute volume alone but rather by this volume adjusted for the simultaneously expiring refinancing operations from earlier periods. After being thus netted, the two three-year tenders created not 1,018.7 billion euro of additional central bank money but "only" 570.4 billion euro, though this still amounted to more than 50 % of all refinancing operations at the time of the second allotment (Chart 36).



137. It should also be noted that the banks initially parked the bulk of this extra liquidity in the **deposit facility** of the European System of Central Banks (ESCB). In other words, the banks hoarded the extra cash as a rainy-day reserve in case the interbank lending channel subsequently dried up. The marked drop in the deposit facility in recent months is connected to the fact that the ECB stopped paying interest on it as from 11 July 2012 and that using the deposit facility causes banks additional work as surplus liquidity has to be transferred at the end of each business day. Part of the funds held by banks in the deposit facility has therefore been rerouted to their regular current accounts at the ECB.

138. The ECB's massive injection of liquidity had a positive impact on the bond markets, at least in the short term. Especially Italian and Spanish banks used the ECB's fresh liquidity at the start of 2012 to buy government bonds. But this further magnified the already dangerously close interconnection between banks and sovereigns (Chart 37, page 26).

139. Another unusual step taken by the ECB was to lower its **minimum reserve ratio**, which it had kept steady for many years at 2 %, down to 1 %, which has reduced the banks' liquidity needs since the start of 2012 by some 100 billion euro. As the minimum reserves are remunerated at the rate charged on the main refinancing operations, this move did not affect bank earnings. It was motivated more by the fact that the banks have an ever smaller amount of eligible assets for collateralizing ECB refinancing operations.

140. The same motive lies behind a third set of measures, under which the ECB has continuously lowered the eligibility criteria for assets to qualify as ECB **collateral**. Expanding the eligible asset pool to include additional types of securities, or assets with a lower credit rating, does not per se automatically increase the risk on the central bank's balance sheet. For one

thing, the ECB charges a haircut on the assets' market value, weighted by default probability. For another, the banks have to remargin if the collateral they have posted loses value over time.

But the danger that the central bank may incur a loss does generally increase with a rising default risk of the posted collateral and thus of higher haircuts on the refinancing loans. First, it is harder to quantify the appropriate haircut for risky bonds than for less risky bonds. Second, haircuts cannot be calculated too highly that they nullify the liquidity impulse of refinancing operations.

Chart 37

3-year government bond yields and securities held by banks by government¹⁾

1) Reading support: In January 2012, the securities portfolio increased by government in the balance sheets of Italian and Spanish banks over the previous month to 28.4 billion euros and 24.7 billion euros.

Sources: ECB, Thomson Financial Datastream

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141. Banks whose collateral fails to meet the ECB's standards can be granted **emergency liquidity assistance (ELA)** by their home central bank. Central banks can offer ELA refinancing at their own risk in return for collateral that the ECB would not deem eligible. The ECB Governing Council can, however, limit a member central bank's discretion to offer ELA by a two-thirds majority. Such irregular refinancing is also mirrored in the Eurosystem balance sheet. It has been used not only by the central banks in the euro-area crisis countries but also, temporarily in 2008, by the Deutsche Bundesbank.

In April 2012 the ELA claims, which up to then had been booked under several different asset items, were aggregated into the position "Other claims on euro area credit institutions in euro". It became clear that large-scale ELA is currently being granted by the central banks of Greece, Ireland and Cyprus. The Greek central bank has provided its banks with more liquidi-

ty via ELA than any other euro-area country. In addition, this item has undergone major fluctuations in Greece recently in connection with the suspension in July 2012 of Greek sovereign bonds' eligibility as collateral for ECB refinancing operations.

142. In the aggregate, the ECB's raft of measures has made a key contribution to stabilizing the banking sector in the crisis countries. The extent of these financial institutions' reliance on central bank funding can be seen in their sharply rising share of the ECB's total refinancing. At the start of 2006 the five crisis countries accounted for one-fifth of refinancing, and today four-fifths (Chart 29, left, page 16). These facts demonstrate two things. First, policymakers at both national and European level need to do much more to stabilize the situation of banks in the crisis countries sufficiently for them to regain the full confidence of national and international investors. Second, the high capital outflows show that many investors have doubts concerning the continued existence of EMU (Box 6, page 4 ff.). This downward slide can only be reversed if both national and European policymakers act resolutely to permanently resolve both the country-specific and the systemic problems.

3. How high are the dangers of inflation?

143. The massive bond purchases by the Fed and the BoE, the ECB's announcement that it would buy unlimited amounts of bonds, and the generally very large expansion of central bank balance sheets have stoked widespread fears in the general public about price stability.

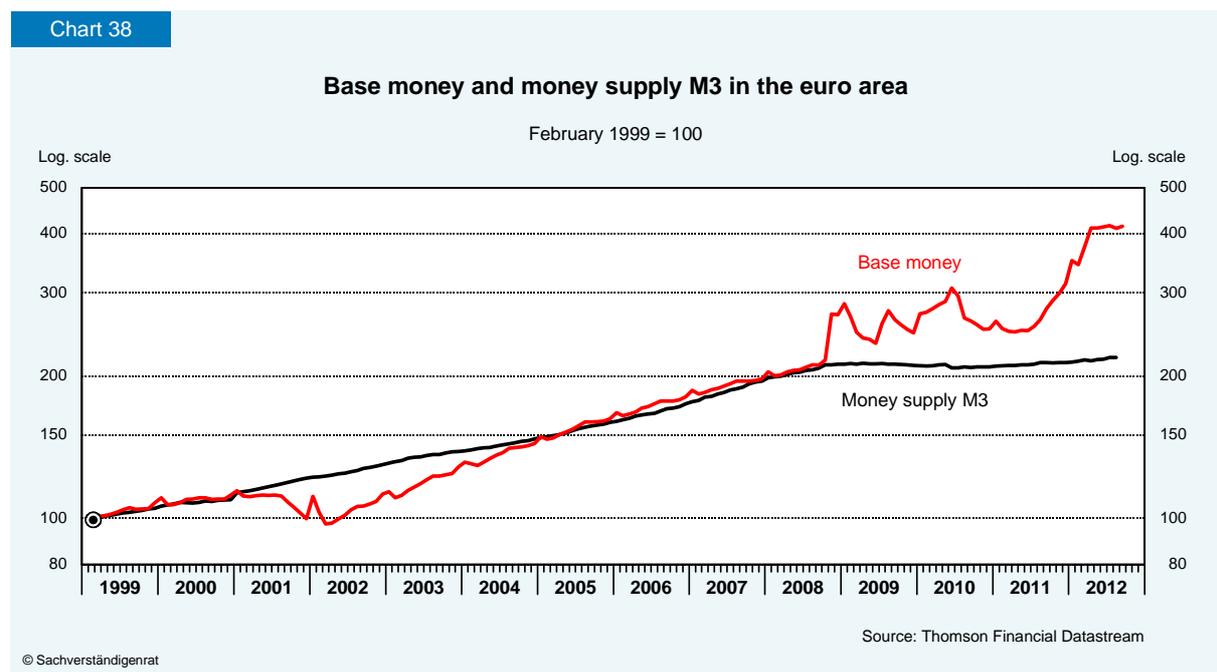
144. But one problem in this context is the frequent failure to distinguish clearly between different components of the **monetary aggregates**. In the euro area the big jump in refinancing loans has led to a marked rise in banks' credit balances at the ECB. For a time this greatly enlarged the **monetary base**, made up of currency in circulation plus banks' central bank balances. Yet this variable is only of secondary importance as an indicator of inflation. Studies carried out by the ECB (ECB, 2011) show that the **M3 monetary aggregate** is a more important barometer of inflation. It amalgamates the relatively liquid assets of non-banks. Its main components are currency in circulation, overnight deposits, deposits with an agreed maturity of up to two years, deposits redeemable at notice of up to three months, and bank debt securities with a maturity of up to two years.

145. Whereas the monetary base has expanded strongly in recent years, M3 has been growing more moderately since the collapse of the investment bank Lehman Brothers, and a lot more slowly than the ECB's reference value of 4.5 %. The very divergent trends in the two monetary aggregates are due, on the one hand, to banks' high precautionary cash holdings at the ECB and, on the other hand, to the restrained lending to the private sector, which is closely related to M3 growth (Chart 38, page 28).

146. It cannot be ruled out that the banks may sooner or later use their present store of liquidity at the ECB for granting loans to firms and households. But the ECB can at any time raise the money market rate, which is a key determinant of **banks' credit supply**, so as to prevent excessive monetary growth. It could also do so within the remaining maturity of its LTROs by increasing the interest rate on the deposit facility accordingly. In view of the euro area's

gloomy economic outlook, however, it is unlikely that the ECB will need to tighten its monetary policy stance for the time being.

Besides these monetary factors, the **situation on the labour market** has a key bearing on the inflation trend. It decisively influences growth in real wages, which in turn determine firms' scope for raising prices. Given the extremely poor employment prospects in the euro area as a whole, it is highly unlikely that workers will have enough bargaining power in the next few years to win substantial real wage increases. In the crisis countries wages are more likely to fall further.



147. High sovereign debt is often seen as a possible cause of inflation. Sustainable public finances are characterized by the fact that public debt is eliminated over time through real primary surpluses, i.e. a state must consolidate sooner or later. An indebted state can use central bank money in order to repay its debts, or increase inflation so as to reduce the real value of its debt, or it can generate a bigger central bank profit by expanding the money supply. All these options give it an incentive to abandon the pursuit of monetary stability. Higher inflation rates then arise because states choose to avoid the politically uncomfortable route of cutting expenditure or increasing revenue (Woodford 2001, 1994; Christiano and Fitzgerald 2000). The EMU member states do not have these options. The regulatory rationale of EMU is precisely to stop member states from funding their public budgets by printing banknotes.

148. While it is true that all major phases of inflation have been triggered by government borrowing financed by the central bank, it should also be noted that Japan, which for years has had the highest debt ratio of all OECD countries, has been on the verge of deflation for quite some time.

Japan's apparently paradoxical development can be explained by the phenomenon of **balance sheet recession** (Eggertsson and Krugman, 2012; Koo, 2003). This explanatory approach sees public debt not as an exogenous shock but as a reaction to a disruption in the private sector. This consists in a high net financing surplus of the enterprise and household sectors. Unlike textbook theory, household savings in such a situation are therefore much higher than the enterprise sector's borrowing requirement for investment. In Japan's case the enterprise sector has itself been accumulating large financial surpluses for decades. Such a constellation can occur, in particular, after a financial crisis if banks, in the course of deleveraging, are unable to grant loans on a large scale and the private sector is seeking to repair its balance sheets through saving. But at the aggregate level this can only be done if the state is willing to take an offsetting position as debtor. In such a setting characterized by restrained investment and consumption, the inflationary effects of government borrowing are limited.

149. But this does not mean that the highly indebted euro-area member states can permit themselves to abandon the course of consolidation. If a country's solvency is questioned because of excessive government debt, a further rise in borrowing can cause its refinancing costs to surge owing to higher expected default risks and to come dangerously close to levels which threaten their solvency (Corsetti and Müller 2012; Corsetti et al. 2010). Although debt consolidation has a negative impact on short-term economic growth, highly indebted countries in the euro area therefore have no other option than to pursue this path. This is especially true as the euro-area member states must first prove that the newly agreed fiscal rules will have a positive effect (section 214 ff.).

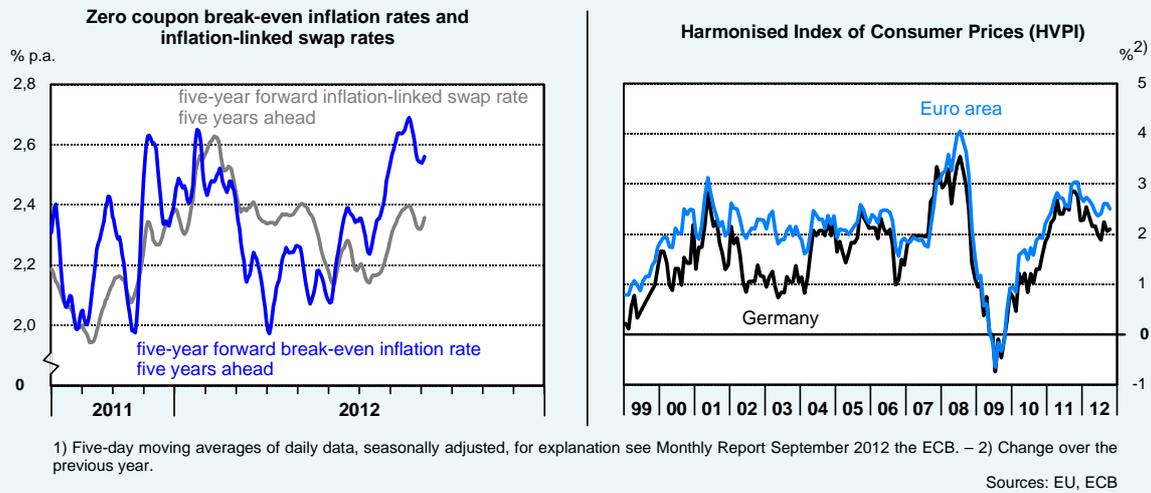
150. That the inflationary dangers are probably being overestimated by the general public can be illustrated by market players' **implied inflation expectation** (Chart 39, left, page 30). These can be calculated on the basis of the yields of inflation-indexed zero coupon bonds. For a period of five years these values, at currently 2.6 %, are a little higher than the ECB's inflation target, but they are still below the average inflation rate of 2.7 % that prevailed in Germany between 1949 and 1998 during the era of autonomous national monetary policy.

This finding matches the results of the ECB's ongoing survey of **inflation forecasts** (Survey of Professional Forecasters). In the third quarter of 2012 this forecast inflation amounted to 2.0 % for the five-year period and was thus on a par with the ECB's target figure.

151. A frequently asked question is whether, given an asynchronous development within the euro area, **monetary stability in Germany may be at risk**, even if the inflation rate for the euro area as a whole is adjacent to the target of less than but close to 2 %. In a monetary union, the national inflation rate can differ from the average rate, since the ECB has to gear its single monetary policy to developments in the euro area as a whole. In the past, deviations have indeed occurred, though mostly downwards owing to Germany's at times very weak economic dynamics. But this deviation never amounted to more than 1 percentage point for Germany.

Chart 39

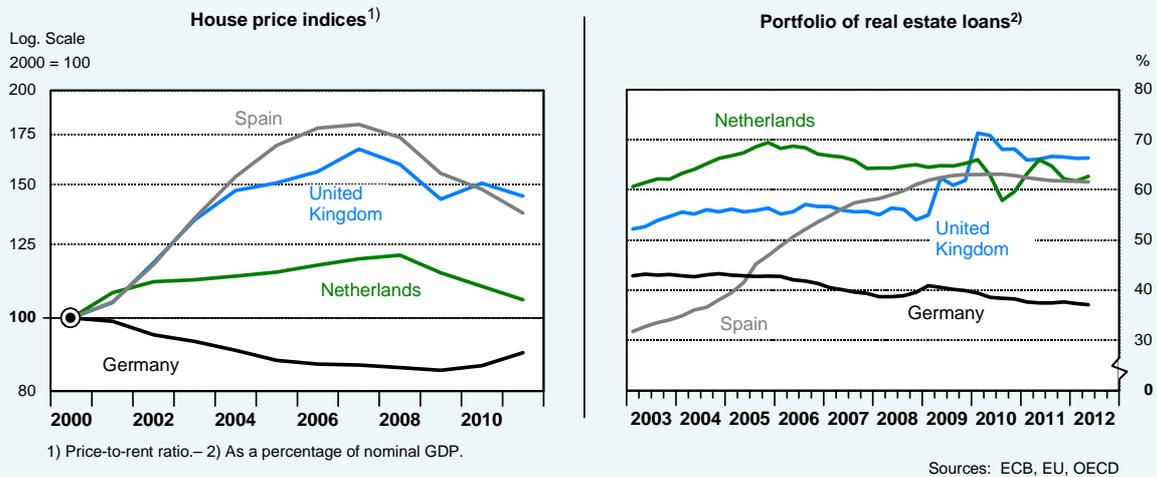
Inflation expectations¹⁾ and actual inflation in Germany and the Euro area



152. More recently, however, not just consumer prices risks but also the development of **real estate prices** in Germany have increasingly come under the spotlight. For some big German cities there certainly are signs of a rapid increase in property prices, although the average nationwide increase in housing prices is fairly small (RWI, 2012). The rise in real estate prices based on the international benchmark ratio of housing prices to rents is currently far below previous trends in European countries that have gone through a house price boom in the past few years (Chart 40, left). Moreover, the ratio of housing loans to GDP has not only held steady in Germany, it is also clearly below the European average (Chart 40, right). This means that the rising price trend in the German real estate sector to date has been more catching up with the average rather than shooting above the fundamentals.

Chart 40

Real estate market development in selected countries



153. Hence it cannot be ruled out for the future that consumer prices might temporarily rise faster in Germany. Such a scenario is unlikely at the moment, however, as the German inflation rate has remained below the euro-area average in the past twelve months despite major differences in economic growth and the employment situation (Chart 39, right). Besides, the past few months have shown that it is rather unlikely that the Germany economy will manage to significantly decouple from developments in other countries. One sign of this is that, since the third quarter of 2011, GDP growth in Germany has been driven exclusively by the external sector, while domestic demand generated negative impulses.

III. Progress towards institutional reform

154. The EU's **institutional framework** has been fundamentally reformed in the past two years through several packages of measures aimed at strengthening economic policy governance (Six Pack, Euro-Plus Pact, Fiscal Compact, Two Pack) and the establishment of a crisis mechanism (ESM).

1. Disciplining fiscal policy

155. One of the key elements of the reform efforts are measures aimed at **disciplining the fiscal policy** of member states in order to avoid excessive deficits and debt levels. A comprehensive European regulatory framework has already existed since the Maastricht Treaty in the form of the **Stability and Growth Pact** (SGP). But it contained several in-built flaws that made it ineffective in preventing excessive debt in numerous euro-area countries. Some of the criticisms made by the German Council of Economic Experts in the past (Annual Report 2009 section 123) have now been addressed.

156. The reformed SGP is clearly more ambitious than the old SGP. Alongside the deficit criterion in the corrective arm, which maintains the upper limit of 3 % of GDP for the deficit level, it now explicitly regulates the debt reduction path, and failure to meet this criterion can trigger an excessive deficit procedure and, ultimately, sanctions. In future, a debt level of over 60 % of GDP has to be reduced annually by one-twentieth of the excess amount over the 60 % ceiling. Another positive feature is that growth in expenditure is at least partly taken into account in the preventive arm. The downside is that the SGP has become even more complex and opaque.

157. Another flaw of the old SGP is that the **imposition of sanctions** has to be approved by the Council. The sanction mechanism therefore lacked credibility as all governments were afraid they might themselves face penalties at some point. The reforms help to address this problem since sanctions can now be initiated earlier on in the excessive deficit procedure by a **reverse qualified majority voting** (Annual Report 2010 Box 8). But the requirement of a qualified majority for initiating an excessive deficit procedure and for the other procedural steps could not be altered in the European regulatory framework as this is enshrined in the Treaties of the European Union. In the new Fiscal Compact the political leaders pledged to introduce reverse qualified majority voting at these stages in the procedure, too. If this politi-

cal pledge proves itself in practice, it would make the excessive deficit procedure considerably less discretionary than it has been in the past.

158. The new rules considerably strengthen the options for applying **sanctions** for infringements of the SGP. Not only have the old sanctions in the corrective arm been increased (fines up to 0.5 % of GDP), new sanctioning options have been introduced at upstream stages of the procedure in the corrective arm and now also in the preventive arm, as well as in the event of statistical manipulation. A further potential extension of possible sanctions that is being talked about – suspending payments of EU Regional Policy – is inappropriate. First, the recipients of these funds are regional and local government entities that should not be blamed for the financial excesses of central government. Second, such conditionality would negate the long-term objectives of the EU's cohesion policy.

159. The incorporation of **fiscal rules into national law**, which was stipulated by the Fiscal Compact, is a new element for avoiding excessive deficits. These debt brakes are based on the level in the SGP's preventive arm and limit the structural (i.e. cyclically adjusted) deficit to 0.5 % of GDP. This means that, in most cases, the new national debt brakes are stricter than the SGP's deficit and debt criteria. When introducing their national fiscal rules, the member states have to meet common standards that are very close to those of the Swiss and German debt brakes, and, if they fail to introduce them, may be penalized by the European Court of Justice. However, monitoring is assigned to independent institutions at national level and cannot be penalized at European level.

160. It is hard to foretell which of the two routes – the obligation to establish national rules or the tightening of the SGP – is the **more promising road to greater fiscal stability**. While the modified SGP is now armed with tougher sanctions and a stronger automatic trigger, its deterrent effect still depends on the member states' political will to actually impose sanctions.

The effectiveness of national fiscal rules for reducing deficits and debt has been attested by numerous studies for European states (Debrun et al., 2008) or Swiss cantons (Feld and Kirchgässner, 2008; Krogstrup and Wälti, 2008). In the past, however, the introduction of such fiscal rules was accompanied by a political willingness to consolidate government budgets, whereas their introduction by way of the Fiscal Compact was largely driven by political pressure, since the euro-area states cannot apply for ESM support unless they ratify the Fiscal Compact. It remains to be seen whether the introduction of national fiscal rules under such circumstances will have a similarly positive impact on budget consolidation.

2. Establishment of a European Stability Mechanism (ESM)

161. The Treaty Establishing the European Stability Mechanism (ESM) that entered into force on 27 September 2012 introduced a permanent crisis resolution mechanism for the euro-area states as a follow-on from the temporary rescue mechanism EFSF. This intergovernmental treaty set up an international financial institution with the aim of mobilizing financial resources and granting financial support to ESM members in crisis situations subject to strict conditionality. An amendment to Article 136 of the Treaty on the Functioning of the Europe-

an Union (TFEU) was passed back in March 2011 which, in particular circumstances and subject to strict conditionality, now allows a temporary assumption of liability despite the no bail-out rule enshrined in the TFEU.

162. The ESM has 700 billion euro of authorized capital stock, of which 80 billion euro is paid in and 620 billion euro is callable. The ESM's effective maximum lending capacity is thus limited to 500 billion euro. In March 2012 it was agreed to prolong the EFSF to June 2013 and thereby to raise the joint credit capacity to 700 billion euro, of which roughly 200 billion euro is already earmarked for the programmes for Greece, Portugal and Ireland.

163. The treaty could only enter into force after the German President had ratified it, by which the stipulation in the treaty that member states representing at least 90 % of the capital requirements must sign up had been met; all member states of the euro area have meanwhile concluded the ratification process. German ratification had to await a ruling of the German Federal Constitutional Court regarding the claim that the treaty infringed the constitutional budgetary autonomy of the German parliament. Although the Court dismissed these claims, it made it clear that not every interpretation of the ESM Act was compatible with the German constitution.

To meet the Court's specific demands, the treaty was supplemented by an official declaration that unambiguously limits the payment obligations of the ESM members to their share in the authorized capital stock of the ESM and makes any higher payment obligations subject to renewed parliamentary approval. In addition, the clarification spells out that the provisions of the ESM treaty concerning the inviolability of ESM documents and the professional secrecy of all persons working for the ESM do not stand in the way of the comprehensive notification of the national parliaments. The German Federal Constitutional Court's judgment did not, however, include a ruling on the challenge to the possible purchase of government bonds on the secondary market by the ECB, which is permissible within the OMT through an ESM programme (Box 8, page 22). This will only be decided in the main judicial proceedings.

164. As a general rule, the ESM's resources are only available to countries that have ratified the Fiscal Compact. The release of funds requires a qualified majority of 85 % of the votes. This effectively gives Germany a veto right. Once a state has applied for ESM funding, the ESM Board of Directors decides which concrete instrument will be used under which conditionality. Five instruments are available:

- ESM precautionary financial assistance (Article 14): These funds can be applied for by countries with structural weaknesses but otherwise sound macroeconomic fundamentals and a sustainable public debt position.
- Financial assistance for the re-capitalization of financial institutions of an ESM member (Article 15): The ESM can grant loans to the government of a state which can use these in order to recapitalize banks. A Memorandum of Understanding has to be signed for the banking sector; a macroeconomic adjustment programme is not a precondition.

- ESM loans (Article 16): Loans may be granted in support of a macroeconomic adjustment programme. These loans have preferred creditor status.
- Primary market support facility (Article 17): The ESM can buy government bonds on the primary market in order to gain (regain) or maintain access to the financial market for its member states.
- Secondary market support facility (Article 18): Finally, the ESM can buy bonds on the secondary market in order to avoid contagion effects and reduce risks to financial stability.

165. Pursuant to Article 12 of the ESM Treaty, all new euro-area government securities must include collective action clauses as of 1 January 2013. However, ESM funding is not tied to the initiation of debt restructuring negotiations. A private sector participation of possible losses in the event of a public finance crisis in a member state was intensely debated in the negotiations on the ESM terms. Although private sector involvement is mentioned in the treaty's preamble, it is not a precondition for a country to receive liquidity assistance from the ESM.

166. Essentially, it makes sense to specify an explicit set of rules for responding to a crisis. Such an ex ante crisis resolution mechanism was lacking at the start of the banking and sovereign debt crisis. This absence increased market uncertainty and was one reason why many economic policy decisions had to be taken ad hoc. However, crisis scenario rules have to be embedded in a reformed long-term institutional framework in Europe, which should encompass greater fiscal discipline, an explicit crisis resolution mechanism and improved regulation of the financial markets. Such a long-term concept should include the possibility of involving the private sector in the costs of a crisis through a debt rescheduling procedure so as to prevent liability mechanisms from being nullified. Within a narrowly defined framework and subject to strict conditionality, liquidity assistance can be meaningful.

3. Further reforms of economic policy governance

167. A new element of economic policy governance in the EU is the **macroeconomic imbalance procedure** (MIP). Like the SGP, it can be divided into a preventive and a corrective arm, although only the existence of an "excessive imbalance" can lead to sanctions. The transparency of the procedure is greatly enhanced by a scoreboard consisting of ten indicators with related alert thresholds, which will be issued annually by Eurostat. But the decision as to whether macroeconomic "imbalances" exist and whether they are "excessive" will not be based solely on the scoreboard but additionally on a qualitative overall assessment.

168. The explicit monitoring of risks emanating from macroeconomic imbalances makes sense in that they led to the current crisis and were only subsequently and partially reflected in the fiscal policy developments covered by the SGP (section 116 ff.). But it is far harder to identify macroeconomic imbalances and define clear-cut alert thresholds by means of individual indicators, such as the current account balance. Hence an approach that is based on a broader set of indicators and gives a certain margin of discretion to the European Commission is preferable to a quasi-automatic procedure.

Moreover, what may be perceived as policy failures are often due to very different and complex causal combinations outside of direct political control (Annual Report 2010 section 171 ff.). A quasi-automatic procedure would therefore create the wrong impression that it is invariably the government's fault. These problems are somewhat mitigated in the case of the MIP, however, as the European Commission and the Ecofin Council cannot impose concrete measures on member states but can only make non-binding recommendations; the corrective action plans are drawn up by the member states themselves. But it must be ensured that the lack of automatic triggers does not lead to a zero response to imbalances. The MIP could help to make the public in the member states aware of country-specific problems. The transparency of the scoreboard, which has attracted attention in the media, and the explicit naming of problems in individual countries by the Commission could play a role in this.

169. The agreed measures aimed at fostering **competitiveness and employment** are less convincing. The **Euro Plus Pact** stipulates only vague goals. The choice of concrete measures is left to each state, and a first evaluation by the Commission shows that these measures – including in Germany – are often based on legislative projects that have already been initiated. In its current form the Euro Plus Pact provides no value added to the pledges contained in the Europe 2020 strategy.

170. Lastly, the **European Semester** set up a yearly cycle of economic policy coordination and surveillance of economic and budgetary policy in the member states. This introduces some new elements such as the Annual Growth Survey, which the Commission submits at the start of the year. But the main goal is coordinating the member states' budget planning in the first half of the year through the timely submission of their fiscal and economic policy strategies (Stability and Convergence Programmes and National Reform Programmes) and their assessment by the Commission and Council. These measures aim to improve the coordination of national budget planning and to achieve that European recommendations are factored into the finalization of national draft budgets. The European Semester is positive in that it enhances transparency by bringing together various components of fiscal and macroeconomic surveillance in a joint framework.

IV. The path from crisis management to a stable architecture for European Monetary Union

1. Crisis management problems

171. Europe's economic policymakers face the ongoing difficult challenge of taking the right steps to stabilize the euro area in the short term. At the same time, they need to ensure that the task of building a long-term **stable architecture** for the EMU, on which a start has already been made, is not allowed to falter. Moreover, the necessary short-term stabilization measures must not take any wrong turnings that would jeopardize the chances of reaching the long-term goal of a coherent regulatory framework for the EMU. That said, there is no silver bullet for overcoming the multiple crises inside the EMU; various economic policy steps – both short and long-term – need to be interconnected:

- Given the constantly climbing debt ratios, it is essential to **consolidate public finances**. While this obviously carries considerable economic risks in a recessionary environment, abandoning the prescribed consolidation path for a time would seriously damage credibility, since it is highly unlikely that the necessary retrenchment steps will be rigorously implemented during the next upturn.
- Competitiveness in the crisis countries can only be restored through **rigorous structural reforms** of the product, labour and financial markets. In a common currency zone, relative prices cannot be adjusted through devaluation. This adjustment necessitates, amongst other things, wage cuts. It is true that, in the short run, such measures reduce domestic demand and increase the private sector's real debt burden. But in the longer run these adjustments and structural reforms are vital to return economies to a growth path.
- The capital outflows from the crisis countries and the contraction of lending show that the banking systems have to be urgently **recapitalized and restructured**. In the process, however, it is crucial to keep liability and control together (section 332 ff.). As long as effective control and restructuring powers have not been transferred to the European level, direct recapitalization of banks by the ESM would negate this fundamental principle. For the foreseeable future, therefore, the countries concerned should themselves remain liable for such funding, even if this pushes up their public debt levels.

172. Ensuring that the necessary steps are taken to overcome the crisis in EMU requires, first, embedding the current **crisis management** in a clear strategy for a **long-term framework** for the EU and EMU (section 173 ff.). Above all, crisis management steps have to be gauged by whether they are **compatible** with such a long-term framework and – if not – are reversible. Second, a roadmap has to be drawn up leading from the present to the long-term goal (section 191 ff.).

2. Long-term framework:

The three-pillar model of the German Council of Economic Experts

173. The crisis has vividly demonstrated that the framework for EMU contained in the Maastricht Treaty was flawed mainly in two important respects. First, member states' fiscal policy was supposed to be disciplined by the SGP and the financial markets, backed by the no-bail-out clause. Yet the SGP was undermined – first of all by Germany and France – between 2003 and 2005. And the **disciplinary effect of the financial markets** was small because they did not demand risk spreads commensurate with the disparate budgetary positions of the individual member states. The undersized risk spreads might be due to various reasons. No advanced economy has defaulted on its payments since the Second World War; government bonds of the euro-area countries are presumed to be perfectly safe under the prevailing financial market regulations; and the markets increasingly began to doubt the credibility of the no-bail-out clause; lastly, the ECB accepted government bonds from euro-area countries as collateral without restriction.

Second, just about no one foresaw the consequences of a deep financial market and banking crisis. For one thing, the old EMU regulatory framework was blind to a crisis on the financial

markets. This permitted a build-up of risks in the financial system which, in the current crisis, endangered the solvency of member states. Furthermore, the European financial system is not capable at this point in time of sustaining the payment default of a sovereign debtor. For another thing, the institutional conditions for coping with liquidity and solvency crises of member states were missing. This is why the **no-bail-out clause** could not be rigorously enforced. These regulatory flaws must be addressed and redressed in a reform of the European Monetary Union.

174. The basic problem of the rescue measures taken to date is that they provide no all-embracing answer to the pivotal question of how the coexistence of an integrated monetary and currency policy and 17 autonomous national budgetary policies and national banking supervision regimes can be smoothly organized once the crisis has been overcome. The German Council of Economic Experts proposed a **three-pillar model** in its 2010/11 Annual Report, and refined it in its 2011/12 Annual Report, which extends the original concept of Maastricht Treaty ("Maastricht 2.0") and outlines such a long-term regulatory framework (Chart 41, page 38):

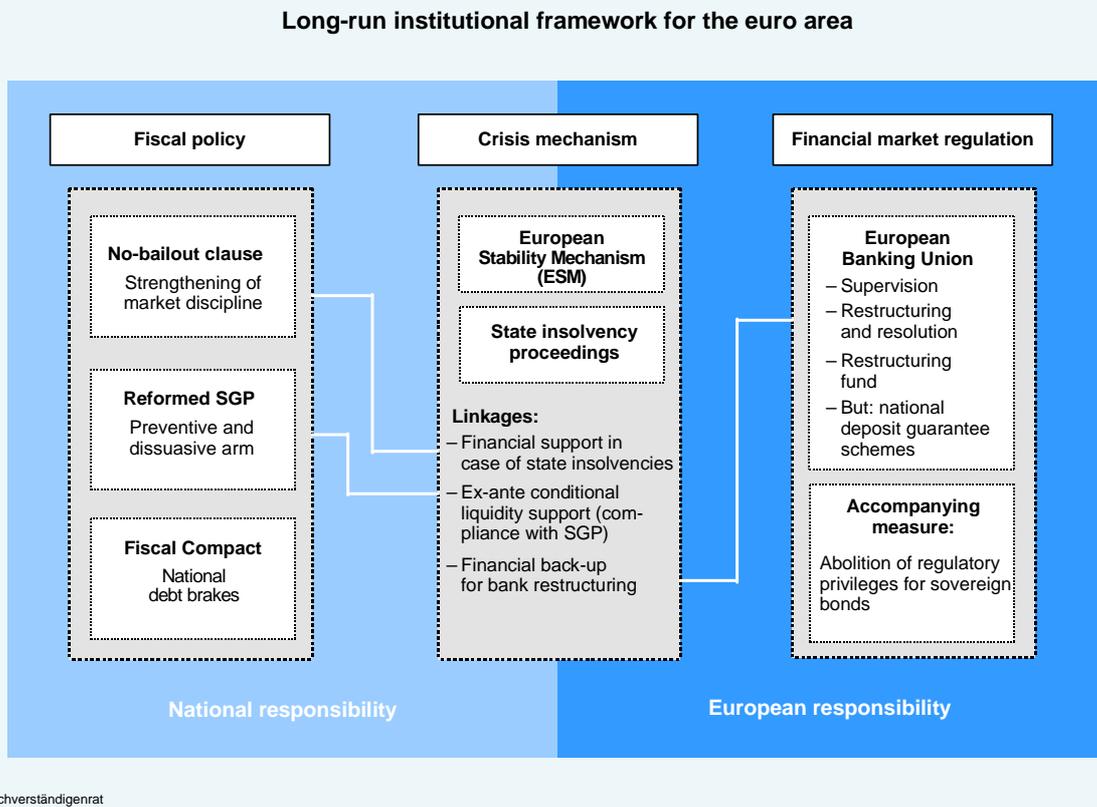
- The **pillar for ensuring fiscal stability** requires credible fiscal rules that set incentives for a sound fiscal policy and effectively punish states with inadequate fiscal discipline. Key steps in this are reforms of the SGP and the national debt brakes agreed in the Fiscal Compact (section 115 ff., 204 ff.).
- Giving the close financial interconnectedness of the banking systems, the **pillar for securing the stability of the financial system** requires a single financial supervisory authority equipped with extensive competencies and powers of intervention. With its concept of a banking union, the German Council of Economic Experts fleshes out this element of its three-pillar model in this Annual Report (section 32 ff.).
- The **pillar for crisis management** requires a permanent set of rules for coping with crises. It must clearly regulate procedures for effectively dealing with sovereign liquidity and solvency crises and combating contagion effects. These include an insolvency regime and a crisis mechanism which, like the ESM, can grant liquidity assistance.

175. Only constellations that keep **liability and control** together are stable in the long term. There are thus two opposing solutions for a credible long-term framework. The one retains future responsibility for fiscal and economic policy largely under **national sovereignty** in line with the regulatory principles underlying the Maastricht Treaty, notably strengthened through improved fiscal rules in the EU. This would require minimizing the permanent joint liability in the area of fiscal policy. The alternative solution abandons the model of national sovereignty in favour of **comprehensive joint liability**, entailing a transfer of fiscal policy sovereignty to the European level.

One of these two diametrically opposed options must be chosen for the various policy areas in order to give the euro area a stable regulatory architecture. Alternative concepts that combine joint liability with national sovereignty for the member states would be extremely problematic. The German Council of Economic Experts' plan for safeguarding fiscal stability relies on

retaining decentralized competencies and, thus, national liability. Safeguarding stability in the financial system, by contrast, requires a greater centralization of competencies owing to the elevated contagion risks inside the EMU. The German Council of Economic Experts' views on a European banking union are set out in Chapter 3 (section 322 ff.).

Chart 41



The fiscal pillar of "Maastricht 2.0"

176. The central issue for the **fiscal pillar** is to what extent the member states are prepared to give up sovereignty. Far-reaching joint liability would necessitate effective central control over the individual states' debt policy. The German Council of Economic Experts considers this unrealistic. Its Maastricht 2.0 conception, by contrast, offers not just long-term stability but also political feasibility. It is firmly based on **national fiscal responsibility** disciplined by the markets. This is the sole option in the absence of credible rights of intervention, which would only be convincing if some central fiscal supervisor – in the form, say, of a European finance minister or a Commissioner for Monetary Affairs equipped with far-reaching powers – were able to give binding instructions to national parliaments, as the budget policy decision-makers of the member states, and to directly intervene **in a top-down hierarchy** in member states' finance and tax administrations.

Intervention rights would not only restrict national budgetary law in that a draft budget judged to be inconsistent with stability could be rejected and referred back to the member states' parliaments. The European authority would also need to be able to influence the implementation of national budgets during the year. It is already extremely difficult for a central government

to give fiscal instructions to its federal states. Such direct intervention would be totally impossible within a confederation of sovereign states.

177. Yet the right to intervene in national fiscal and tax administrations is necessary because otherwise the budgetary guidelines issued by a European fiscal authority could be circumvented at the implementation stage. This is amply attested by past experience in federally organized countries such as Germany. The budgetary autonomy of Germany's Länder relates mostly to expenditure and borrowing, whereas they have not much real tax autonomy. They are also locked into a strongly egalitarian fiscal equalization system within the federal joint liability system. The Länder customarily responded to economic downturns or difficulties in the past by borrowing more, with the result that their debts increased over time (section 377), and individual Länder ran into budgetary crises and had to be bailed out through transfers.

Conversely, tax administration is assigned to the Länder level which, despite the standardization of personal income, corporate and value added taxes, use this power to gain a competitive tax advantage through laxer tax collection (Baretti et al., 2002). All attempts to close down this discretionary leeway so far have failed. More radical reforms, such as the creation of central tax administration with powers to intervene in Länder tax administrations, were rejected by the Länder in the negotiations on the first and second reforms of the federal system.

It has proved equally hard to curb the states' spending. Even when the finances of Bremen and Saarland were in such a dire position that the two states had to apply to central government for a bail-out, the latter was unable to exert influence on their spending. The two Länder subsequently applied for a further bail-out, pleading a renewed budgetary emergency in 2006 and 2009, respectively.

Although the German constitution obliges Länder to comply with federal law – Article 37 (1) of the Basic Law entitles central government, in the case of infringement, to **compel Länder to comply with federal law** – it is unclear (Sierck and Pöhl, 2006) whether state overspending constitutes an infringement of federal legislation justifying intervention by a central fiscal supervisor. Hence not even within Germany is central government able to terminate unsound fiscal policies at Länder government level caused by the segregation of liability and control.

178. Three other nations with a federal structure – the United States, Canada and Switzerland – have addressed these problems of intergovernmental financial relations by establishing a strict **accountability** of the individual states. The federal states enjoy extensive budgetary autonomy on both the revenue and the expenditure side. But they are also fully responsible for their fiscal performance. Liability and control thus remain at the same level. In the United States this included letting states go bankrupt in the past. None of the Swiss cantons has ever got into such a financial plight. Both the USA and Switzerland have long had municipal insolvency laws. In both countries the federal states also constrain their borrowing through more or less restrictive debt brakes, which in the aggregate have led to sound public finances (Feld and Kirchgässner 2008; Sutherland, Price and Joumard 2005; Bohn and Inman 1996).

Brazil is one example of a federation that has implemented something similar to – or even exceeding – the budgetary intervention powers being discussed for the EU. Brazil's Fiscal Responsibility Law (Lei de Responsabilidade Fiscal) imposes strict expenditure and debt rules on both central government and state governments and permits the former to intervene in the budgets of the latter. The law provides for sharp sanctions, including fines and imprisonment, for the responsible persons and contains measures to ensure the transparency of public finances. This law was successful (Liu and Webb, 2011; Rodden, 2003), but of late has led to evasive reactions into off-budget activities. The sharp sanctions have not been deployed to date.

179. In the EU, which is far from being such a federal state, it would be difficult to ensure effective control over national budgetary policies. It is politically unlikely that the sovereign EU member states would tolerate supranational interference. A key reason why Germany and France were unwilling to accept the SGP's constraints in 2003 was the wish to uphold their budgetary autonomy. In addition, the TFEU would have to be extensively revised. Germany's Basic Law would probably have to be replaced by a new constitution pursuant to Article 146 of the Basic Law. Thus after weighing up the alternatives, the Maastricht 2.0 model of national fiscal autonomy and national responsibility, subject to financial market discipline, is the more convincing option for a credible long-term framework for the euro area.

180. The **fiscal pillar of Maastricht 2.0** is thus firmly based on national budgetary autonomy. The member states conduct their own expenditure and revenue policy based on their particular political priorities. This also means that the member states can borrow autonomously. But a single currency area also needs to guard against excessive government borrowing, as otherwise price stability may be endangered. Hence the member states' budget policies need to be sufficiently coordinated to ensure that they do not run up too much debt. The national and European fiscal rules are designed to safeguard this. At the European level the existing SGP rules have been tightened, even though the automatic **triggering of sanctions is too weak**. The task of identifying infringements of the rules in the preventive and corrective arms of the SGP should be taken away from the Council and assigned instead to, say, the **European Commission**. At the national level the Fiscal Compact stipulates the introduction of **national debt brakes**. To ensure that these have a binding effect, infringements should be **challengeable before the European Court of Justice**.

The Maastricht 2.0 plan requires the rigorous implementation of the no bail-out clause. And a sovereign insolvency regime needs to be introduced for the euro area so as to convince the financial markets that the no-bail-out clause will actually be applied.

Crisis management pillar: Insolvency regime and ESM

181. The **pillar for crisis management**, together with the banking union, is a flanking measure in the Maastricht 2.0 conception for the fiscal frameworks at national and European level. This will make the no-bail-out clause credible. The objective of the institutional framework is primarily to **prevent crises** and only secondarily to resolve crises that have already occurred. This requires **insurance elements** to protect member states and the financial system against

contagion, together with a **sovereign insolvency regime**. This would define rules for allocating losses in the private sector, thus strongly boosting the disciplinary effect of forward-looking risk assessment (Annual Report 2011 section 242 ff.).

182. What is needed is an institution that performs a **dual function**. On the one hand, it will manage sovereign insolvencies and provide bridge financing to the insolvent member state if necessary. On the other hand, it will provide member states with insurance against liquidity crises that may arise through no fault of their own, e.g. because of the insolvency of another member state and the ensuing contagion effects. The ESM could assume this role in principle, but its present design is insufficient. What is especially missing at the moment is an insolvency regime for sovereigns and the corresponding ex ante qualification for obtaining liquidity assistance by virtue of pursuing a certified sound fiscal policy.

183. The German Council of Economic Experts presented such a concept for a long-term framework for the euro area in its Annual Report 2011. Under this concept the member states would have access to the ESM depending on their debt ratio:

- States with a debt ratio of less than 60 % that experience a liquidity crisis obtain rapid access to an ESM loan, but this would be limited in amount. This corresponds to the IMF's stand-by arrangements. To avert moral hazard, the member states would have to qualify by ex ante good conduct in terms of the SGP.
- States with a debt ratio of between 60 % and 90 % would receive an ESM loan only if they undergo a multi-year macroeconomic adjustment programme. This approach is in line with the current EFSF/ESM programmes with ex post conditionality.
- States with a debt ratio of over 90 % would receive an ESM loan only if, on top of undergoing a macroeconomic adjustment programme, their sovereign debt is subject to a restructuring involving the private sector.

Owing to its long-term perspective, such a crisis resolution mechanism can only be introduced once the debt overhang from the past has been eliminated. Whether this mechanism can successfully avert negative incentives will depend on the due diligence examination as to whether the liquidity crisis occurred through no fault of our own. It follows that precautionary credit lines should only be available in such cases or in extraordinary crisis situations.

184. In its current form, the ESM's "precautionary financial assistance" vividly illustrates how much short-term crisis management can conflict with the long-term regulatory framework. Access to this financial assistance can be applied for by member states that demonstrate solid macroeconomic fundamentals and, especially, a sustainable government debt position. But under certain circumstances the assistance can also be claimed by member states that are undergoing an excessive deficit procedure. The German Council of Economic Experts takes the view, however, that ex ante qualification for liquidity assistance should be coupled to the condition that member states continuously comply with the SGP rules and have not merely complied with the Council's recommendations for overcoming the excessive deficit. Meas-

ured by these criteria, most of the euro-area member states would have little chance of obtaining precautionary ESM financial assistance for the foreseeable future.

Maastricht 2.0 is the basis for a stability union

185. Under the Maastricht 2.0 concept the euro-area member states would basically retain national responsibility for fiscal policy – embedded within the coordinated early warning and disciplining regime of a reformed SGP. This also means that they would be responsible for organizing the funding of their activities themselves; common financing of sovereigns with joint liability is just as impermissible as ex post bail-outs of member states that have over-borrowed and thus lost access to the financial markets.

However, the current crisis has shown that a narrow focus on fiscal targets – as was enshrined in the original Maastricht Treaties – which disregards the financial sector cannot prevent the build-up of excessive debt in the private sector. These problems have spilled over to sovereigns and have thereby undermined fiscal policy stability objectives. Excessive debt ultimately means borrowing that exceeds the level that is sustainable, given existing differences in competitiveness and real economic structures. The starting point should therefore be to improve the incentives in the financial sector in such a way that debt levels do not increase excessively in the future.

186. For these reasons it is consistent to combine decentralized liability and control of fiscal policy with greater centralization in financial market regulation via a banking union. In the field of financial markets a greater degree of centralization of prudential and resolution competencies is necessary owing to conflicts of aims between monetary and fiscal policy, on the one hand, and banking supervision, on the other (section 304). The United States and Switzerland have adopted a similar line by pursuing a strict no bail-out rule at state level while opting for uniformly regulated financial markets and a high degree of risk-sharing through the financial markets.

Financial market regulation is a central policy field, since bank balance sheets ultimately mirror undesirable developments in both the real economy and in the fiscal field. At the same time, however, it must be clearly understood that greater centralization of competencies in this area implies giving up sovereignty and therefore cannot be achieved without a treaty amendment. Furthermore, if in cases of bank distress a resolution cannot be achieved without recourse to fiscal resources, clear ex ante criteria have to be defined for fiscal burden-sharing (section 312). Otherwise the solution of problems in the banking sector will fail on the fundamental principle of fiscal sovereignty.

A different opinion

187. One member of the Council, Peter Bofinger, has a different opinion regarding the fiscal pillar of the long-term framework, which is set out below.

188. Instead of the Maastricht 2.0 model featuring national sovereignty, the architects of the fiscal pillar could decide to resolutely deepen the process of European integration (Bofinger, 2012). Under this approach the portion of sovereign debt held in national liability that does not exceed the 60 % ceiling stipulated in the Maastricht Treaty could be transferred to common bonds with joint liability (**blue bonds**). Any portion of a country's debt that exceeds this ceiling would remain under national liability (**red bonds**). This proposal of Delpla and Weizsäcker (2011) would have the advantage that a large stock of safe assets would be created for the financial markets. Particularly insurance companies and pension funds have a high demand for such assets, but banks, too, need secure government bonds for liquidity and collateral purposes.

189. Permanent joint liability could indeed only be justified if it were backed by extensive safeguards against states with unsound fiscal discipline. This would require creating direct powers of hierarchical intervention in the event of clear fiscal misconduct by an individual country that exceed the existing disciplinary measures stipulated primarily in international agreements (section 154 ff.). This role could possibly be assigned to the institution of a **European finance minister** or a **monetary commissioner** elected directly by the European Parliament and thus enjoying the necessary democratic legitimacy. Such a transfer of national sovereignty to the European level would not normally entail further constraining the autonomy of national parliaments.

The debt brakes agreed in the Fiscal Compact already restrict parliament's decision-making autonomy regarding revenue and expenditure to some extent. And if a member state complies fully with the terms of the debt brake, there would be no need for the European level to intervene in national decision-making processes. This would only be necessary if a national budget no longer meets the stipulated requirements. In that case, the authorization by the European finance minister would be necessary. If a parliament were unable on its own to submit an acceptable budget, the European finance minister would need to have the option to instruct the country in question to temporarily increase taxes or cut spending by a given percentage.

190. It is hard to say at the moment whether the EMU member states would be willing to accept such a surrender of national sovereignty. But, for one thing, national fiscal policy action is already de facto subject to tight constraints, and, for another, in return for giving up part of their sovereignty the countries would be offered the prospect of permanent joint liability. It is questionable, however, whether such supranational intervention is legally compatible with national constitutions or the European treaties and whether it would be exercised in practice. Despite the SGP's somewhat unconvincing track record, it should be noted that under Euro 2.0 the imposition of sanctions would no longer be decided by the "club" of national ministers but instead by a superordinated European institution completely independent of national governments.

That was the opinion of Peter Bofinger.

3. Bridges to the long-term framework

191. Member states' vulnerability to crises of confidence will remain so high for years to come that the strict application of the no bail-out rule, which is a fundamental feature of Maastricht 2.0, might be accompanied at any time with situations that endanger the stability of the entire euro-area financial system. The IMF projects that the crisis countries' debt ratios will stay around 120 % and more for a number of years; only Spain will manage to fare a little better with a debt ratio of around 100 %.

The step-by-step approach pursued so far by the policymakers adds up to a significant advance towards Maastricht 2.0. Despite the necessary criticism of certain details and some remaining gaps, reforms have been initiated that would have been inconceivable even a short while ago. One major shortcoming, however, is that the step-by-step approach has produced no credible fiscal policy solution that shows a way forward out of the present crisis.

Risks of a permanent ECB rescue function

192. The sole reason why the crisis management has so far not led to an escalation of the crisis is that the ECB has stepped in repeatedly to stabilize both the banks and the bond markets. But this carries considerable economic and political risks in the longer term:

- On the one hand a "**Japanese scenario**" is conceivable, characterized by undercapitalized banks, weak lending, insufficient investment and many years of weak economic growth. The prevailing deflationary trends could be amplified if the recessionary developments in then crisis countries cannot be fully overcome in the coming years. Confidence in these countries' banks would then be lastingly damaged, which would put the ECB under ongoing enormous pressure to offer generous refinancing.
- On the other hand, a scenario is conceivable that leads in the medium term to significantly **higher inflation rates** than hitherto. This would be triggered by fiscal policy. The ECB interventions might encourage individual states to ease up on their retrenchment efforts and on the implementation of structural reforms. This would put the ECB in the difficult position of either continuing to stabilize such a country by buying its bonds or stopping its support, even if, in the case of a larger member state, this would cause substantial dislocations and the danger of systemic crises on the financial markets. If the ECB decided to maintain its support, this would open the floodgates to irresponsible fiscal policies that would generate such inflationary tendencies in the medium term.

193. The ECB's involvement in crisis management is frequently justified by the assertion that its involvement is reversible and thus poses no obstacle to a long-term equilibrium in which fiscal liability and control are located at the national level. Two arguments, in particular, refute the proposition that the ECB could exit its crisis management role faster than a dedicated institution which was explicitly set up as a long-term bridge to the future, such as the European Redemption Pact proposed by the German Council of Economic Experts.

First, in exiting its crisis management role, the ECB would face an unavoidable conflict of aims between safeguarding price stability and financial market stability. If the ECB were to focus solely on its mandate of ensuring price-level stability, it would have to be prepared to increase its key interest rates so as to curb rising inflation rates. It would then have to accept negative repercussions of interest rate rises on the value of its government bond holdings and on the debt sustainability of some member states.

Second, the ECB's emergency interventions are **clearly inferior, and not just for reasons of moral hazard**, to credible fiscal policy solutions because the ECB is unable to influence banks and states directly. The biggest danger to the future of EMU today is that the emergency solution of shifting responsibility to the ECB could become a **permanent arrangement**. Following the ECB's announcement of the OMT, it has become much easier for politicians in all the member states to let the monetary policymakers do the job of restoring stability rather than pushing through bold (and doubtless highly unpopular) structural reforms and austerity measures. The **ECB lacks the democratic legitimacy** for taking on such fiscal policy functions.

The European Redemption Pact

194. This is why it is necessary to build a fiscal bridge leading credibly from the unavoidable short-term stabilization measures to a sustainable and stable regulatory framework for the euro area. Such a regulatory framework is provided by the European Redemption Pact proposed by the German Council of Economic Experts (Annex I, Special Report 2012). It is designed as a system of mutual obligations for solidarity and solidity. It features **limited joint liability** – limited both in amount and time – in the European Redemption Fund and is connected with strong safeguards to the European Redemption Pact. The financial framework opened up by this joint liability for each country is the difference between its actual debt ratio and the 60 % ceiling laid down in the Maastricht Treaty. The total joint liability would amount to roughly 2.6 trillion euro (Chart 42, page 46).

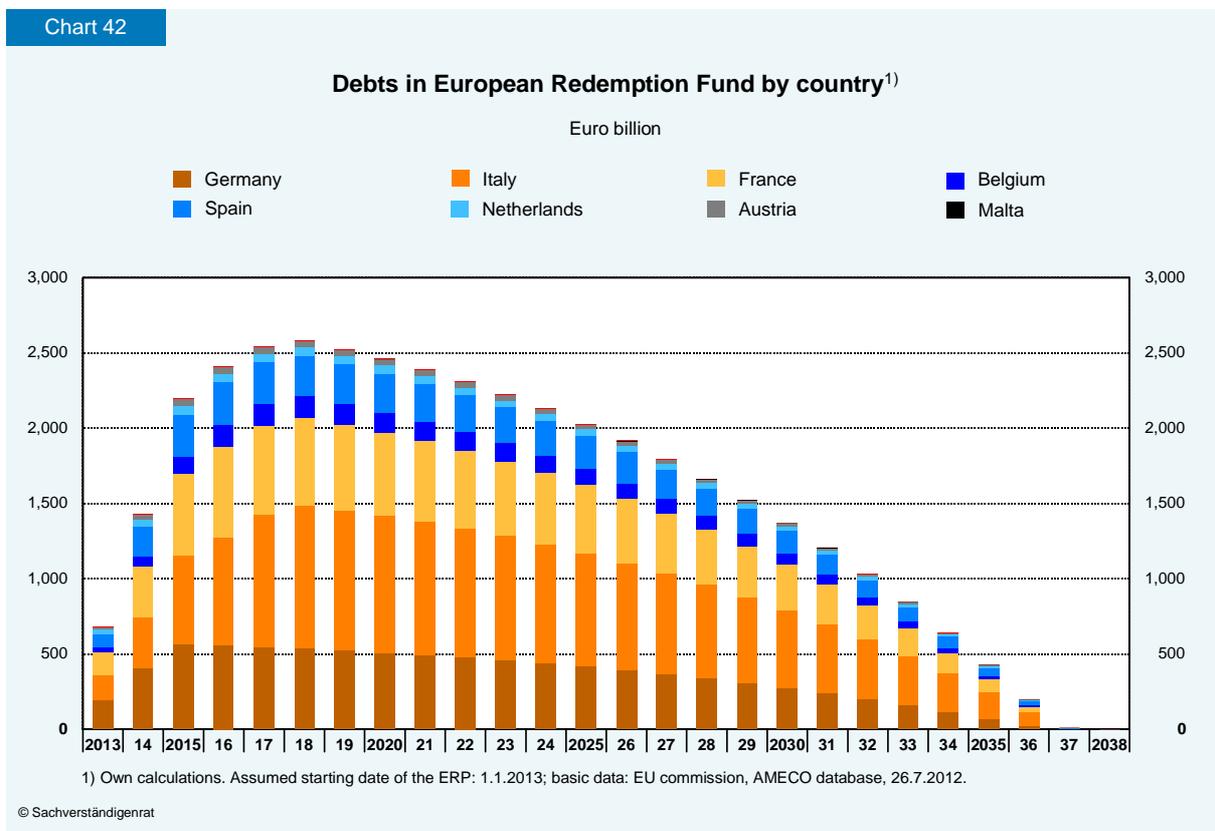
It would not fully accumulate until the end of a roll-in phase of up to six years, however, as the joint liability of the European Redemption Fund would only be assumed for new bond issuances. Hence the consolidation efforts and structural reforms demanded in return for this solidarity can be convincingly initiated well before the full liability volume has accumulated. Once the roll-in phase has been completed, the redemption phase would begin, during which the fund volume would gradually be reduced. After around 25 years the outsourced debt will have been fully repaid, so that by 2038 all the bonds issued under the joint liability will have been fully redeemed.

195. As the German Council of Economic Experts explains in detail in its Special Report, the European Redemption Pact comprises **strict safeguards** (Annex I, Special Report 2012, page 407 ff.). These include amongst others:

- Ex ante implementation of a **national debt brake** to underpin the credibility of the consolidation commitments,

- **Consolidation agreements** which explicitly map how the individual member states will cut their structural budget deficit to a maximum of 0.5 % of GDP during the transition period,
- The obligation to specify certain (if necessary new) **taxes** that will be earmarked for paying interest and redemption payments, and
- The posting of **collateral** amounting to 20 % of the outsourced debt. This could be, for example, a country's foreign currency and gold reserves, and member states could additionally back their bonds with real property mortgages. These would be surrendered if a country failed to meet its payment obligations.

Chart 42



If at the end of the redemption period all joint-liability bonds have been fully redeemed and the debt ratios of all member states are down to the reference value of 60 %, the conditions to move forward to Maastricht 2.0 will be met. It would then be possible to rely on national liability and the disciplining function of the markets.

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