Press Release

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German Council of Economic Experts discusses reform needs to make the euro area more stable and proposes sovereign insolvency mechanism

The recent conflict between the government of Greece and its partners in the euro area has shaken the very foundations of European Monetary Union. According to the German Council of Economic Experts, an independent body that advises the government in Berlin, these tensions have underlined the high urgency for further reforms.

As a result, the Council of Economic Experts has published a special report about strengthening the architecture of European Monetary Union. Under the heading "Maastricht 2.0", the Council reiterates its concept for a long-term framework, whose guiding principle is the unity of responsibility and liability at national and European level.

As part of this, the European banking union should be deepened - the Single Resolution Mechanism for insolvent banks needs to be fleshed out further, and a fully independent financial supervisory authority created. In addition, the links between banks and sovereigns need to be severed. Above all, the euro area's crisis mechanism should be complemented by a mechanism for orderly sovereign insolvencies and should stand firm against any uncooperative, debt-stricken government. Strict adherence to euro area fiscal rules remains the only way for governments to deal with high sovereign debt.

Insolvency procedures for euro area member states

"The goal is to reduce sovereign debt through the consistent application of fiscal rules, and to make the no bail-out clause credible by establishing a sovereign insolvency mechanism," said Christoph M. Schmidt, Chairman of the German Council of Economic Experts. "To ensure the cohesion of monetary union, we have to recognize that voters in creditor countries are not prepared to finance debtor countries permanently."

According to the Council, a sovereign insolvency mechanism would be an important tool to prevent crises. Much like the recently agreed creditor-participation in the event of bank insolvencies, a sovereign mechanism would force creditors to shoulder losses if states went bankrupt. This would spur investors to assess sovereign risk in more detail.

Given high euro area sovereign debt levels, the Council views the introduction of fixed debt thresholds for bankruptcy proceedings as impracticable in the near-term. But that should not stop euro area governments from starting work on an insolvency regime

immediately. This would reduce the chance that taxpayers would again have to take over the risks of sovereign bondholders when a state stumbles over its debt mountain.

A permanently uncooperative member state should not be able to threaten the existence of the euro. In view of this, the Council of Economic Experts recommends that the withdrawal of a member state from the currency union must be possible as an utterly last resort.

Greek crisis distracts from successes of European crisis policy

The recurring debates about assistance for Greece should, in the Council's view, not distract from the evident successes of euro area crisis policy. Firstly, it managed to avert a systemic crisis in the currency area, which would have done great damage to all its member states. Secondly, important institutions like the banking union and the ESM were created to make the euro area more resilient. Thirdly, assistance programs adopted by debt-stricken states shielded their citizens from the worst effects of the crises.

"Without the help of their European partners and the IMF, the crisis countries would have been forced to make much more painful adjustments," said Professor Schmidt. "The emergency loans extended the necessary fiscal consolidation over several years. As a result, the rescue packages contributed to preventing even greater austerity. "

Critics of euro area policy had called for crisis countries to be allowed to "grow their way" out of their debts. The Council's view is that such an approach would have been doomed in Greece given the structural rigidities of the country's economy.

The economic turnarounds in Ireland, Portugal, Spain and - until the end of last year - also in Greece show that the principle "loans against reforms" can lead to success. For the new program to work, Greece has to show more ownership for deep structural reforms. And it should make use of the technical expertise offered by its European partners.

Quick-win policies could pose risk in the long term

The Council warned that some policies designed to quickly deal with acute problems could become a risk to the euro area in the longer term. In consequence, the Council rejects reforms currently being discussed, for example, the creation of a euro area fiscal capacity, a European unemployment insurance scheme, or an economic government for the currency bloc. Making the euro area collectively responsible for potential costs without member states giving up any national sovereignty over fiscal and economic policies would – sooner or later – make the currency union more unstable.

One of the five members of the German Council of Economic Experts, Peter Bofinger, expressed a dissenting opinion about major points addressed in the special report.