After the Euro Area Summit: Time to Implement Long-term Solutions

Special Report

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This is a translation of the original German language version, which is the sole authoritative text.
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# Special Report:
“After the Euro Area Summit: Time to Implement Long-term Solutions”

## CONTENTS

<table>
<thead>
<tr>
<th>I</th>
<th>Time for a permanent solution to the Euro crisis</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Multiple crises in the Euro area</td>
<td>1</td>
</tr>
<tr>
<td>2</td>
<td>Crisis management</td>
<td>4</td>
</tr>
<tr>
<td>3</td>
<td>Using the time gained</td>
<td>7</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>II</th>
<th>A pact for sound sovereign finances</th>
<th>10</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>A European Redemption Pact for the Euro area</td>
<td>12</td>
</tr>
<tr>
<td></td>
<td>The European Redemption Fund</td>
<td>12</td>
</tr>
<tr>
<td></td>
<td>Precondition for access: ratification of the Fiscal Pact</td>
<td>12</td>
</tr>
<tr>
<td></td>
<td>Strict conditionality</td>
<td>13</td>
</tr>
<tr>
<td></td>
<td>Sanctions by interest mark-ups</td>
<td>13</td>
</tr>
<tr>
<td></td>
<td>Earmarked taxes</td>
<td>14</td>
</tr>
<tr>
<td></td>
<td>Collateral</td>
<td>14</td>
</tr>
<tr>
<td></td>
<td>Disciplinary effect of the markets</td>
<td>14</td>
</tr>
<tr>
<td></td>
<td>Veto rights by the main guarantors</td>
<td>15</td>
</tr>
<tr>
<td></td>
<td>Independence of the European Redemption Fund’s Directorate</td>
<td>15</td>
</tr>
<tr>
<td>2</td>
<td>Up-dated calculations</td>
<td>15</td>
</tr>
<tr>
<td>3</td>
<td>Legal considerations</td>
<td>20</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>III</th>
<th>Laying the foundations for a stable financial system</th>
<th>22</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>The European banking sector in crisis</td>
<td>22</td>
</tr>
<tr>
<td></td>
<td>A long-term regulatory framework for the European banking sector</td>
<td>24</td>
</tr>
<tr>
<td></td>
<td>Principles for government recapitalization of banks</td>
<td>27</td>
</tr>
<tr>
<td></td>
<td>What is to be done</td>
<td>28</td>
</tr>
<tr>
<td></td>
<td>Summary</td>
<td>30</td>
</tr>
<tr>
<td>1</td>
<td>Acute crisis management</td>
<td>30</td>
</tr>
<tr>
<td>2</td>
<td>Make up for lost time</td>
<td>31</td>
</tr>
<tr>
<td>3</td>
<td>No overhasty moves toward a banking union</td>
<td>31</td>
</tr>
</tbody>
</table>

Bibliography ......................................................................................................................................................................................... 32
Time for a permanent solution to the Euro crisis

1. Having at times eased during the first few months of 2012, the mid-year saw an escalation of the Euro crisis. Unstable economic and political conditions in Greece were an additional factor fuelling the debate on a “Grexit” and thus as a whole impaired the already hard-hit confidence in the stability and integrity of the European Monetary Union (EMU) as a whole.

The risk premiums on long-term Italian and Spanish government bonds have risen considerably compared to German bonds once again; indeed, by mid-2012 they reached a level similar to the one seen in autumn 2011. The increasing uncertainty among investors from or based in the Euro area is also reflected in the on-going increase in TARGET2 balances in the EMU. Deutsche Bundesbank’s claims as at end of May 2012 totalled € 699 billion. The situation was also destabilised by dampening economic conditions in the countries in distress. This year, Italy, Spain and Portugal have all become caught in the throes of a harsh recession and, in Greece, we are seeing a veritable depression. The number of unemployed persons has surged in all the countries on the EMU’s southern periphery, with the rate of youth unemployment in Greece and Spain now above 50 per cent.

1 Multiple crises in the Euro area

2. The Euro area faces three severe and closely interrelated crises: a sovereign debt crisis, a banking crisis and a macroeconomic crisis. What is especially dangerous here is that these crises are mutually reinforcing, thus culminating in a crisis of confidence that casts into doubt the very existence of the monetary union itself (chart 1).

Vicious circle of banking, debt and macroeconomic crises

1) Economic downturn leading to debt default

Banking crisis

Credit crunch decreases investment

Macro-economic crisis

Banks bailed out by government impairs government budget

Declining tax revenues and increasing transfers adversely affect public households

Debt crisis

Default on government bonds impairs banks’ balance sheets and capital levels

Unavoidable government consolidation weakens domestic demand

1) According to Shambaugh (2012).
3. **Sovereign debt crisis and banking crisis**: The loss in the value of government bonds with increasing yields negatively affects the balance sheets of banks. In the first half of the year, the banking systems in the countries in crisis became even more exposed to sovereign risk, as above all Italian and Spanish banks have used the liquidity generously made available by the European Central Bank (ECB) to acquire government bonds.

That said, specifically in Ireland the government rescue packages for the banking sector have considerably increased public debt. The uncertainty over the future scale of write-downs required, for example, in Spain’s financial sector, is nurturing additional doubts in the viability of public-sector financing. Despite comparatively low debt-to-GDP before the crisis, these countries therefore currently also face doubts whether they can service their debts in the long term (chart 2).

4. **Sovereign debt crisis and macroeconomic crisis**: The cost-cutting programmes, that are imperative in order to consolidate public budgets, harm the already weak domestic business cycles in the countries concerned. As a reaction, the cycle then causes lower tax revenue and rising public expenditure for unemployment, such that the respective government’s financial position deteriorates. Moreover, because sovereign debt is usually construed as a ratio, namely as the ratio of gross debt to nominal gross domestic product (GDP), a recession also leads to a decline in the denominator in this ratio and to an increase in the debt-to-GDP ratio.

Nevertheless, it is crucial that the countries successfully realign macroeconomic conditions in order to service the debts, which have largely accumulated abroad. Unlike in the case of independent monetary policy, the countries in crisis are unable to support sectoral restructuring by opting for the external devaluation of their currency. As a consequence, the process has to
occur exclusively through a painful **internal devaluation**, with resources from the sectors more strongly aligned to the domestic economy (such as the public sector in the case of Greece or the construction sector in the cases of Ireland and Spain) being diverted to sectors with so-called tradable goods. Given the macroeconomic requirements, there is no escaping this sector restructuring process.

5. **Banking crisis and macroeconomic crisis**: The economic recession with rising unemployment and falling property prices leads to a deterioration in the quality of banks’ credit portfolios in the countries in crisis. Facing increased regulatory and market-based capital requirements, banks can resort only to **deleveraging**, meaning a reduction in credit volumes. This further undermines corporate investment activities and private households’ demand for real estate loans. The resulting process of negative loans growth can be observed in all the countries in crisis with the exception of Italy (chart 3).

On the other hand, a functionally viable financial system is a key precondition for the necessary **sectoral realignment of the economies**, as investments need to be financed to spur economic growth. The dilemma is that the financial system is hit hard in precisely those countries, where high foreign debt particularly sparked speculative developments in the property sector. A high share of non-performing assets strains the balance sheets of banks. The loss in confidence has caused private capital flows from abroad to dry up and in their wake, loan approvals in these economies have been dented, making the necessary macroeconomic adjustments all the more difficult.
2 Crisis management

6. Despite the recent exacerbation in the crisis, there is no overlooking the fact that at both the national and European levels politicians have over the last 12 months succeeded in taking **courageous steps to initiate consolidation** of public financing. The EMU member states have strengthened the Stability and Growth Pact and in the form of the Fiscal Pact have jointly committed to implementing binding ceilings on the structural deficit at the national level. Moreover, as part of the deficit procedure innate in the Stability and Growth Pact the regime of sanctions has been made tougher, and this has strengthened the European Commission’s position vis-à-vis the respective countries and their finance ministries. Finally, steps to consolidate budgets have been taken in many of the countries in crisis (chart 4).

7. The fact that these steps are not yet reflected more clearly in the budget trends can be attributed, firstly, to the scale of the **problems of competitiveness** that have grown over the years in which the EMU has existed, triggering further need for reforms. Secondly, it can be
attributed to the negative impact of cost cutting on the business cycle and thus on tax receipts and expenditures sensitive to the business cycle. Fiscal policy in all countries in crisis is clearly on the right path, as is shown by the trend for cyclically adjusted budget balances. This finding is all the more pronounced if one also considers the situation in the United States, the United Kingdom and Japan, where to date hardly any notable effort has been made by these countries to reduce their very high deficits.

8. A comparison with these countries also shows the special challenge that the problem countries in the EMU have faced since the crisis broke out. Despite hardly any noteworthy efforts to consolidate, the United States, the United Kingdom and Japan are currently able to secure refinancing in capital markets at all-time low interest rates (chart 5). By contrast, the markets have not to date rewarded the cost-cutting programmes in the countries in distress in any way. Instead, the risk premium for Italy and Spain in June 2012 was about twice as high as in the previous year. This trend may seem surprising at first glance and can be explained by the fact that EMU member states are in a fundamentally different situation than a country such as the United Kingdom, which exclusively carries debt in its own currency. Moreover, the Bank of England is prepared as part of its policy of quantitative easing to engage in large scale operations in the bond markets. At the same time, such a policy blurs the dividing line between monetary and fiscal policy.

The exposure of the countries in crisis to the financial markets results from the fact that their total debt is carried in a currency that they cannot themselves produce. This can essentially be grasped as a desirable disciplining effect, but can easily also set a destabilizing process in motion whereby rising interest on bonds makes state financing even harder, leading in turn via negative confidence levels to investors demanding higher yields. Such a vicious circle, fuelled additionally by fears of the possible exit of a country from EMU, emerged for
the first time in autumn 2011. At the end of 2011 the spiral was initially brought to a halt by the ECB pouring extensive liquidity into the market. By Q2 2012 the effect of that move had diminished, with interest premiums rising again to a threatening degree.

9. Given this state of affairs, the heads of state and government in the Euro area took various decisions at the **European Council meeting** of 28-29 June 2012 with the purpose to steady the situation in the short term.

This included in particular the decision to use the **instruments of the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM)** “in order to stabilise markets for Member States respecting their Country Specific Recommendations and their other commitments including their respective timelines, under the European Semester, the Stability and Growth Pact and the Macroeconomic Imbalances Procedure. These conditions should be reflected in a Memorandum of Understanding” (Euro Area Summit Statement, 29 June 2012).

The Council of Economic Experts would like, however, to repeat its proposal first outlined in the Annual Economic Report 2010-11. The Council developed a model for a European Crisis Mechanism that conditions access to a common financing mechanism to the degree to which a country adheres to the conditions of the Stability and Growth Pact (AER 2010 item 160). In other words, unconditional access would be open only to those countries whose budgets are not in the excessive deficit procedure. Moreover, one should bear in mind that, after deducting the disbursements made to Portugal, Greece and Ireland as well as the programme for Spanish banks, the financial resources of the EFSF and ESM total at most € 400 billion, which suffice only to cover the annual financing requirement of Italy and Spain once (table 1).
can it sever the negative feedback loop between the banking and sovereign crises. Establishing sufficient supervisory and intervention powers will not least require a considerable amount of time, something that does not exist in the current situation.

Another short-term contribution to stabilising the financial markets will take the form of the ESM providing the financial assistance Spain receives for its banking systems from the EFSF, but without thereby assuming the role of prime creditor. While such risk sharing may be questionable in terms of overall regulatory principles, it can yet be justified on the grounds of the systemic importance of the Spanish financial system for the stability of the Euro area banks and for insurance companies.

10. All in all, the Euro area heads of state and government have only given the countries in crisis a breather. It would be far too optimistic to consider the decisions as being the final solution to the crisis. Assuming, as is most probable, that the economic situation deteriorates further, it will be very difficult for the countries concerned to achieve the deficit targets set, which may further dent financing on the capital markets. Additionally the banks’ situation will worsen further, meaning that the financial framework available through the EFSF and the ESM could swiftly come up against its limits. Given the Spanish and Italian financing requirements, totalling € 1,052 billion through the end of 2014 (table 1), a rescue programme in keeping with the model for Ireland or Portugal is inconceivable.

3 Using the time gained

11. Policy makers should therefore use the time gained with the measures now resolved in order to implement more comprehensive solutions as quickly as possible, whereby these require more far-reaching contractual and statutory changes. The Council of Economic Experts devised a concept in November 2011 in the form of the European Redemption Pact (ERP) that on the one hand would enable stability-focused countries to take up refinancing at interest rates that would not be distorted by the tension in the financial markets. On the other hand, through the repayment obligation, the ERP ensures that the debt issued under joint and several liability remains only temporary in nature and also comes with extensive collateralization. Given the afore-mentioned interdependencies of the three crises a solution geared only to tackling the sovereign debt crisis is inadequate. It must therefore be buttressed by country-specific structural reforms in the countries concerned and firm measures to stabilize the European financial system. The Council of Economic Experts therefore presents a Reform Agenda for the banking system.

12. The Council of Economic Experts is aware that in the event of joint and several liability for the other Euro area member states, Germany assumes risks that cannot entirely be avoided even given comprehensive collateralization mechanisms. Yet one should not overlook the fact that a strict position against all forms of joint and several liability entails risks that are at least as great. It is conceivable that if the status quo is maintained then two scenarios may arise which are equally unfavourable for the EMU:
− Due to ever higher risk premiums, Italy and Spain could be forced either to opt for a debt haircut, which would have far-reaching consequences for banks in the Euro area, or to exit EMU. These countries would then be able to enact a currency law that would switch their debt over to a national currency and thereafter procure the necessary financing through what would once more be an autonomous national central bank.

− In order to avert some uncontrolled break-up of the EMU, the ECB could decide an unlimited acquisition of Spanish and Italian government bonds, which would be tantamount to indirect liability. From the politicians’ point of view this might have the short-term advantage of not requiring parliamentary approval. Compared with the ERP, this involves liability unlimited in time and quantity, something that would moreover occur without any collateralization and conditionality. In the long run, this path would therefore be highly problematic.

13. In Germany, there are repeated and ever more strident calls for the potential exit of individual countries from the EMU and even for a split into a “Northern Euro” and a “Southern Euro”. The central problem of such proposals is that in the eyes of the financial markets the exit of a single country itself constitutes a fundamental regime change. When making their investment decisions, investors not only have to consider the debtors’ solvency, but also the risk that these may, when repaying the debt, be in a foreign currency zone and no longer part of the Euro area. Such fears can trigger a reallocation of capital that renders conditions in the financial systems in the possible exit countries far harder and can swiftly turn into a self-fulfilling prophecy. The process can spark a chain reaction eating its way ever deeper into the core of the currency zone and at the end of the process, even Germany and France might break apart in terms of monetary policy.

14. For Germany, an uncontrolled collapse of the Euro area would entail great risks.

− For the German financial industry, for German corporations and private individuals, a dissolution of the currency union would spell significant losses. All in all, the claims outstanding from the Euro area totalled € 2.8 trillion at the end 2011 (table 2); this figure does not include foreign receivables due to Deutsche Bundesbank from the Euro area (incl. TARGET2 receivables), which ran at € 530 billion at year-end 2011. About € 1.5 trillion are attributable to corporations and private individuals. In the event of the reintroduction of national currencies, one cannot expect that the debtors in the distressed countries would be able to completely service their liabilities.

− In the short term, there could be a shockwave of uncertainty such as was to be seen after the collapse of US investment bank Lehman Brothers in 2008. Back then, German economic output sagged five per cent.

− The revaluation associated with the reintroduction of the Deutsche Mark would in the long run considerably burden the German economy’s international competitiveness both in Europe and on the world markets. One should not forget that German companies have in recent years benefited considerably from the fact that they manufacture inside a monetary union, moreover one whose currency the markets do not consider a typically “hard currency” in the way that they rate the Japanese Yen or Swiss Franc. Experiences in these
countries, as well as in China and in Germany in the period of the Bretton Woods fixed exchange rates (AER 2011 item 156) show that attempts to defend competitiveness in an economy by intervening in the foreign exchange markets leads to high foreign reserves accumulating that ipso facto finance the United States’ sovereign debt.

### Table 2

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<th>Country</th>
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<td>316.1</td>
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1) Does not include claims of the Deutsche Bundesbank.  
2) Greece, Ireland, Italy, Portugal and Spain.

Source: Deutsche Bundesbank
II  A pact for sound sovereign finances

15. The Euro area is facing a stiff confidence crisis, which means policy-makers can no longer opt for easy solutions. Essentially, the high public debt levels and the erosion of competitiveness in some member states are mutually reinforcing. As a consequence financial market participants tend to strongly doubt whether all sovereign debtors will be able to fully service their debt. The uncertainty regarding sovereign creditworthiness is undermining the confidence in those financial institutions exposed to the distressed countries. This fuels a systemic crisis in confidence, which will only be overcome if a credible strategy to terminate it is announced. That strategy must show not only how public debt in all Euro area member states can be cut back to a level that financial market players believe is viable, but at the same time how structural reforms will be carried out such as are compellingly necessary to reduce the macroeconomic divergences between the member states. The various paths to consolidation must be presented to the financial markets in a plausible manner and adherence to the respective policies must be given sufficiently strong institutional roots.

16. Policymakers have to date made the mistake of not grasping the confidence crisis as a systemic problem, but instead tackling the problems individually. After initiating a series of concerted measures to support highly indebted EMU member states that have lost market confidence, European policymakers now continue to lag behind the markets instead of being ahead of the curve and embarking down credible consolidation paths. European policymakers have adopted a strategy of small steps in which they attempt to respond to newly arising incidents by further expanding the rescue plans or changing access to the EFSF or ESM. In each instance the measures only go as far as the situation necessitates. With each new spiral in the crisis, new negotiations have to be held on expanding the rescue measures.

Despite the intrinsic logic of this strategy (namely to keep the rescue plans as small as possible and thus minimise the joint liabilities shouldered), it is the core cause of the repeated intensification of the confidence crisis, because market participants must worry continuously that the political will at the national and European levels may not suffice to take further steps as these become necessary. Only two years ago, politicians credibly assured the markets that there could be no talk of the monetary union breaking up. Now many sides are talking openly about this possibility and in part even baldly threatening it. In such a climate, long-term consolidation and adjustment programmes can hardly be credible let alone foster confidence among market participants.

If the policymakers continue to unilaterally expect that the consolidation and adjustment programmes will also overcome the systemic crisis in the Euro area, then they run the risk of intensifying existing instabilities to the point that EMU member states drift into a solvency crisis. Only if the ECB thereupon furnishes massive liquidity will it be possible to ward off a renewed financial crisis or even the break-up of the Euro area. Indeed the ECB has already bought up government bonds on a large scale and thus made liquidity available to the markets. As a result, liability without any conditionality has risen considerably. The dividing line between monetary and fiscal policy has been blurred in a dubious manner.
17. In other words, resolute action is required to solve things. The member states that will have to shoulder the considerable burden of adjustments in coming years need to be taken out of financial markets’ sights for a limited period, however without completely suspending **market discipline**. At the same time, there must be a credible commitment to carry out the adjustments. In the medium term, both a reduction in joint liability for debts and a return to full market discipline are necessary in order to enable the due assessment of viable financial policies by actors impervious to political influence.

18. A comprehensive solution to the debt crisis must therefore meet the following standards:

a. The rescue measures must not lead to risks automatically being shared by the EMU member states. Instead, a strategy for solving the crisis must focus on returning to a **stability union**, as envisaged in the Maastricht Treaty. However the path to a stability union will not be possible without a temporary expansion in guarantees. Attention must therefore be paid (i) to ensure that the true scale of the risks shouldered is and remains transparent for citizens. Moreover, (ii) guarantees must be in place to ensure that assistance is always subject to strict conditionality and entails the possibility of sanctions being imposed to penalize adverse behaviour.

b. In order to restore the **separation of monetary and fiscal policy** the ECB should as far as possible not be involved in the further steps to overcome the crisis. Its mandate has already been stretched to the very limits of what is permissible. In the final instance, the unconventional monetary policy measures have led to considerable risks being assumed and quasi-fiscal transfers made without any conditionality or democratic control on the part of the member states furnishing the guarantees. Any solution must therefore decisively grant the key guarantors a veto right.

c. The solution should not only ensure that the country-specific structural problems are overcome, but also that the systemic crisis in the EMU is solved. To dissolve the systemic crisis of confidence, the Euro area member states must therefore choose a way out of the crisis that constitutes a **credible commitment to the Euro** and its continued existence.

d. The solution must comply with the **prerequisites of European and constitutional law**. In particular, the so-called no-bail-out clause in Article 125 of the Treaty on the Functioning of the European Union (TFEU) and the new article 136 para 3 TFEU must not be violated. Moreover, it must be certain that the preconditions under constitutional law are met as they arise from the judgements passed down by the German Constitutional Court on the Act Agreeing to the Treaty of Maastricht of 12 October 1993 (BVerfGE 89, 155ff.), on Germany’s entry into the third phase of the Economic and Monetary Union of 31 March 1998 (BVerfGE 97, 350ff.), on the Act Agreeing to the Treaty of Lisbon of 30 June 2009 (BVerfGE 123, 267ff.) and on the Euro rescue measures of 7 September 2011 (NJW 2011, 2946ff.). In particular, consideration shall be paid to the limitation of the measures taken in time or regarding the volume for which liability is carried as well as the German Parliament’s scope to comprehensively exercise its control over its budget in the future.
1 A European Redemption Pact for the Euro area

19. In its Annual Economic Report 2011-2 the Council of Economic Experts outlined the concept of the European Redemption Pact (ERP). This pact is based on three pillars: a European Redemption Fund (ERF) that envisages temporary and limited joint and several liability for debt in Europe; the Fiscal Pact, which is meant to give national fiscal policy enduring soundness by imposing suitable restrictions; and an insolvency regime for states to come into force after the reduction of debt in the ERF. The objective behind the proposal is to restore national responsibility in fiscal policy in line with the bail-out clause in the Treaty of Lisbon. Access to the ERF is contingent on translation of the Fiscal Pact into national (constitutional) law, in particular the introduction of debt brakes. Joint and several liability for part of the debt will be temporal and of limited scale. The ERP features a series of safety barriers and sanctioning mechanisms to ensure a successful transition to sound public finances.

Below we first reflect on, develop and concretise further on the ERP in light of the changed economic conditions. In particular the first pillar, namely the ERF, was extensively criticized, mainly in Germany. We have taken these points of criticism into account while developing and further concretising the concept.

The European Redemption Fund

20. The proposal for the ERP hinges on the Euro area member states, which are not already on an adjustment programme, to outsource their debt which exceeds the Maastricht Treaty limit of 60 per cent of GDP at a specific date to a European Redemption Fund (ERF) for which there is joint and several liability. In return, the member states taking part assume payment obligations to the ERF that depend on the scale of debt outsourced and shall be set such that the debt can be completely repaid in about 25 years. In this way, each country itself fully repays the debt it outsources and remains liable for the debt it has entrusted to the ERF.

21. Outsourcing debt to the ERF occurs over a multi-year transition period in which the refinancing requirement for coming years is successively covered by the fund until the total volume of debt above the 60 per cent threshold, as was outsourced and conclusively specified in advance, is then reached. After the completion of this roll-in phase, the debt not outsourced to the ERF complies with the 60 per cent debt ceiling stipulated in the Maastricht Treaty. Government refinancing through the ERF is then structured by the purchase in primary markets of long-term government bonds (over two years) and issued by the countries in question. In other words, the redemption fund does not substitute for the individual member states as the debtor. Government bonds with terms of up to two years are part of the national debt that, according to the threshold of the Stability and Growth Pact, shall not exceed 60 per cent of GDP.

Precondition for access: ratification of the Fiscal Pact

22. Debt can only be outsourced if a national debt brake has already been implemented, guaranteeing the credibility of the commitments to consolidation. The debt brakes should be aligned to the goals of the reformed Stability and Growth Pact. In the Fiscal Pact signed by 25...
member states on 2 March 2012 (BT-Drs 17/9046, 6ff.) all the member states that come into question for participation in the European Redemption Pact committed to introduce such debt brakes. Nevertheless, the Fiscal Pact does not go as far as the concept tabled by the Council of Economic Experts (AER 2011 item 190). According to it, in the context of the ERP the binding character of the debt brakes foreseen in the Fiscal Pact should be tightened.

23. In particular, an independent European body such as the European Court of Justice should assess the national debt brakes to be implemented in terms of their substantive coherence and binding character. If a country violates the conditions for its debt brake an immediate penalty payment to the ERF would be imposed, something to which the member states would commit themselves prior to participating in the ERP (analogous to the “debt solidarity charge”, AER 2009 item 128). This penalty payment would, however, need to be higher than previously agreed. Since all states participating would be Euro area members, one option would be to have each violation to the terms of the debt brake ascertained by the European Court of Justice automatically trigger a payment of the share of the ECB central bank profits accruing to the country in question to the ERF - by way of a redemption payment brought forward.

The penalty payment could, however, also be triggered on the basis of the ECB central bank profits accruing to the country in question. In this case, the payments made to the ERF by the ECB central bank account would be increased by an amount equal to the redemption payment. This would mean that the penalty payment would be higher than the penalty payment previously agreed.

24. Outsourcing debt should be tied to strict conditions analogous to the EFSF or ESM rules. At the latest after completion of the roll-in phase, the nationally implemented debt brakes should be fully binding and thus replace the conditionality of the roll-in. For the period of the roll-in phase the participating member states would therefore conclude so-called consolidation agreements among themselves. These treaties would explicitly state how, during the transition phase, the individual member states will reduce their structural budget deficits to a maximum of 0.5 per cent of GDP, as envisaged in the regulations concerning the debt brake.

In a similar way, agreements could be made on implementing structural reforms on the basis of which the partner countries could constantly monitor progress made in consolidating public finances and in enhancing competitiveness. Should there be cause for suspecting that individual member states are not adhering to the agreements, then outsourcing of debt to the redemption fund would be suspended. The country in question would then have to fully refinance itself through the capital markets, meaning that withdrawing possible refinancing is an effective sanctioning tool.

Sanctions by interest mark-ups

25. One way of maintaining adherence to the conditionality during the roll-in phase and thereafter would be to grant a country only part of the interest advantage if not all conditions are met. Equally, malpractices in fiscal policy after outsourcing the debt could be punished by raising the interest on the outsourced debt accordingly and charging a mark-up on the interest rate originally agreed between the country and the ERF. To this end, specific key budget-policy variables could be included in a scorecard whereby, depending on the degree to which
the latter is fulfilled, the advantageous interest rate offered by the ERP would be granted to the country in question either in full or only partially.

26. In the event of violations of the consolidation agreement, the ERF could resort to another graduated sanctioning tool by selling government bonds of the country in question, thus increasing the supply of such bonds and indirectly pushing the refinancing costs for purely nationally issued paper up. Such **open market operations** by the redemption fund could strengthen the market’s disciplining effect. There would need to be an agreement on dividing up the fund’s annual balances between the member states in order to render such a policy operative.

**Earmarked taxes**

27. Each country that uses the ERF must also collateralize repayment of the debt it has outsourced to the fund. For example, certain (possibly new) taxes could be assigned for this purpose and used to service the obligations. The individual member states could in this way, analogously to the solidarity surcharge in Germany, introduce a surcharge on a tax of their choice the receipts of which would accrue to a (blocked) account. In this context, a surcharge on Value Added Tax (VAT) would seem the obvious choice. This surcharge would be used by way of anchoring political commitment to repay the debt in the fund. It also offers leverage for sanctioning a country if it does not meet its commitments under the ERP. For example, one option would be for a country to have to raise the tax surcharge by a percentage defined in advance should it relax its efforts to consolidate.

**Collateral**

28. Furthermore, as discussed in our AER 2011-2, collateral totalling 20 per cent of the debt to be outsourced would need to be deposited with the ERF. This could be drawn from a country’s currency or gold reserves and member states could also pledge covered bonds. If a country does not meet its payment obligations, the fund can then resort to this collateral. If such a breach of contract arises, the collateral mentioned would automatically accrue to the redemption fund without a European committee having to first make a political decision. The collateral would thus primarily serve to limit the joint and several liability borne by all the partner countries in the Pact and also reduce the moral hazard innate in joining the ERP.

**Disciplinary effect of the markets**

29. Decisive is, that the ERF as an institution is at no point a complete substitute for the **markets’ disciplining effects**. The redemption fund reduces the costs highly indebted member states have to pay for refinancing such that there can be greater success in consolidation. Yet initially market discipline remains firmly in place as government bonds with terms of up to two years cannot be refinanced through the ERF. These bonds remain national debt, which may total at most 60 per cent of GDP. Secondly, a country is completely exposed to market discipline if, following the roll-in phase, it has to refinance the remaining debt of up to 60 per cent of GDP. Thirdly, the open market policy of the repayment fund enables to specifically use market forces to discipline a country.
Veto rights by the main guarantors

30. Compared with assuming further liability for risks via the central bank balance sheet, the ERP has the advantage that help can be pegged to conditions that have to be met and, in the event of violation, sanctions can follow, such as a partial or complete suspension of disbursement. Moreover, the governance structures of the ERP can be set such that Germany can more easily stop the continuation of support payments compared to the channels it has on the ECB Council, which on principle decides by simple majority. In the case of the ERP, the Federal Republic of Germany would have to have a veto in light of constitutional law such as applies to Germany’s participation in EMU according to the decisions by the German Constitutional Court even most recently. The German Parliament’s right to control its own budget could then be guaranteed by corresponding specifications for intra-state political decision-making in European Union matters.

There is a degree of similarity between the consolidation agreements of the ERP and the adjustment programmes put forward by the Troika of the European Commission, ECB and International Monetary Fund. However, consolidation agreements are made through the ERP and support granted before the member states participating have lost access to the capital markets, meaning the ERP functions not only as a crisis mechanism to guarantee the stability of the Euro area as a whole, but also preemptively, increasing the prospects of successful consolidation.

Independence of the European Redemption Fund’s Directorate

31. In addition to the disciplining force of the market, there are legal commitments which constrain national fiscal policy for the duration of the ERF. These include the aforementioned collateral, interest mark-ups and strict consolidation stipulations as conditionality. The proposed expansion of penalty payments as part of the Fiscal Pact even involves national fiscal policy for an unlimited period. These measures can be seen as an array of instruments to securely guarantee the intended consolidation effect. Moreover, the decision-making structures in the ERF must guarantee the wide-scale independence of its directorate. This is justifiable in terms of democratic principles, given that the institution is limited in time and would only mean a temporary and partial waiver on sovereignty by the member states. However, it bears considering also to entrust to this institution the supervision of the national financial statistics. The ERF could alternatively be integrated institutionally into the ESM. It would then also need to be designed as an international financial institution. Voting rights on decisions by the redemption fund would, like the ESM, be exercised by the member states in line with their capital share.

2 Up-dated calculations

32. The ERF’s exact volume, the shares held by the individual member states in that volume, and its duration in time all depend on the exact shape of the roll-in phase and the assumption on the ERF’s refinancing costs and future economic growth. The Council of Economic Experts presented calculations on the ERF’s volume in its AER 2011-2, whereby the computations based on the assumption that the ERF would be in place on 1 January 2012. If
we now assume its foundation on 1 January 2013 then the volume is firstly higher, as the debt levels of the member states participating developed far worse in 2012 than could be assumed six months ago. Secondly, Cyprus will have become a programme country and therefore be no longer eligible for the ERF.

33. The Council of Economic Experts’ updated calculations on the ERF volume are based on the following assumptions:

a. The ERP will start on 1 January 2013.

b. All macroeconomic parameters of importance for the ERP are taken from the current EU Commission forecast for the current 2012 year. The GDP growth rate for the participating member states for 2013 has likewise been taken from that forecast. For subsequent years we assume nominal (real) annual growth of around 3 per cent (1 per cent).

c. We draw on the Maastricht Treaty debt threshold when calculating the volume of debt outsourced.

d. Assumptions on the ERF’s refinancing costs are made drawing on the current refinancing costs for similarly guaranteed bonds, such as those of the EFSF and the European Investment Bank (EIB). Assumptions on refinancing costs for bonds purely issued by a state are summarized in table 3 below. Taking into account that long-term bonds protect against a direct rise in average interest rates, we also assume that the average interest rate rises steadily to the higher level within seven years.

<table>
<thead>
<tr>
<th>Table 3</th>
<th>ERP1) Key figures for participating countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross domestic product</td>
<td>Public debt</td>
</tr>
<tr>
<td>2012</td>
<td>ERF2)</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Germany ........</td>
<td>Euro billion</td>
</tr>
<tr>
<td>France ..........</td>
<td>Euro billion</td>
</tr>
<tr>
<td>Italy ...........</td>
<td>Euro billion</td>
</tr>
<tr>
<td>Spain ...........</td>
<td>Euro billion</td>
</tr>
<tr>
<td>Netherlands ......</td>
<td>Euro billion</td>
</tr>
<tr>
<td>Belgium ..........</td>
<td>Euro billion</td>
</tr>
<tr>
<td>Austria ..........</td>
<td>Euro billion</td>
</tr>
<tr>
<td>Malta ............</td>
<td>Euro billion</td>
</tr>
</tbody>
</table>

1) European Redemption Pact. – 2) European Redemption Fund.

Source for basic data: EU
We do not consider short-term indebtedness (maturity of up to two years) when calculating the volume of the bonds financed via the ERF during the roll-in phase. This prolongs the roll-in phase. In Italy, it is now six instead of previously five years. Spain will cover almost its entire (long-term) financing requirement over the first three years.

34. Given these assumptions, the roll-in phases will last a maximum of six years, after which the fund volume will reach its maximum of €2.6 trillion (chart 6). The largest share of this will be held by Italy with 36.9 per cent of the outsourced debt, followed by France with 22.5 per cent and Germany with 20.8 per cent. After the completion of the roll-in phase the member states involved move into the redemption phase, during which the fund volume gradually declines. After 25 years the outsourced debt will have been completely repaid. As the volume of the ERF gradually decreases, the volume of bonds issued jointly falls, until, in 2038, all bonds issued under joint and several liability have been completely redeemed (chart 7).

35. **Payment obligations** to the ERF should be defined as a fixed proportion of GDP. Unlike payments to private borrowers, the payments to the fund will therefore fluctuate with the economic cycle. In this way, at the European level at least temporarily there will be an automatic stabilizer with mutual insurance against asymmetric shocks that will, however, not be linked to any negative incentives at all. Obligations by a country to the redemption fund will always need to be repaid until the debt outsourced by the country including the interest accrued has been completely repaid.
36. The allocation level could be defined, for example, in such a way that each country would in the first year it participates repay one per cent of the debt outsourced to the ERF and additionally make interest payments on its own share in the fund. The GDP share of these allocations would thus remain constant; the allocations would rise nominally over time while the burden in terms of GDP would remain constant. Payment obligations to the fund exist until all of a country’s debt has been repaid. The member states participating enjoy an interest advantage from outsourcing the debt, and this can be used to repay the debt without placing an extra strain on national budgets. This would benefit in particular those member states with especially distressed public finances. Only Germany and the Netherlands would face an additional charge.

37. The advantages of the ERP may alternatively be achieved via a ERF that is not jointly and severally collateralized. If the risks and sums shouldered by the member states involved are to be more strongly limited, then instead of joint and several liability for the ERF (as with the EFSF) there could be partial liability and excess collateralization. In order to obtain refinancing terms halfway as favourable as with joint and several liability, the guarantees would need to exceed the actual volume of debt outsourced, but would be far lower than for joint and several liability. If the debt to be outsourced is taken as the benchmark, then each country would have to guarantee about 210 per cent (190 per cent) of its debt to be outsourced if the ERF’s bonds are to enjoy the same rating as French (Belgian) government bonds. Each country would then commit to the (theoretical) event of complete liability, requiring them to take up foreign debt of some 110 per cent (90 per cent) of the sum outsourced in addition to its own debt.
38. The volume of liability associated with the ERF cannot simply be added on to the volumes of the rescue plans and facilities already launched. Through the ERP it should be possible to avoid further resorts being made to the funding still available under the main rescue plan. Furthermore, this will break the vicious cycle of sovereign and bank debt, allowing the ECB to withdraw from temporarily having to refinance the banking sector due to the crisis. The difference between the ERP and the measures already put in place is less the scale of jointly shouldered risk and more the fact that this can be rendered transparent by the ERP and the guarantees furnished can come with conditionality, something the ECB cannot impose. Moreover, unlike the assistance provided by the rescue plans the guarantees come to bear even before a country is completely cut off from the capital markets.

39. Given the joint and several liability for the sovereign debt outsourced to the ERF, the member states participating in the ERP face lower average refinancing costs – the only exceptions presumably being Germany and the Netherlands. The primary balances required to comply with the consolidation paths prescribed by the ERP thus fall quite considerably in some member states and make it realistic in the first place to possibly reduce the ratio of debt to a level below 60 per cent of GDP.

For example, Italy would, without participating in the Pact, require a primary surplus of up to 7.1 per cent of GDP in order to comply with the consolidation paths set by the ERP. The ERP would, in contrast, cause the primary balance required to fall to 4.2 per cent of GDP (table 4). This figure is at the upper edge of the primary balance ratios that by historical comparison have proved sustainable over a longer period of time. In other words, it is the ERP that first makes a return to a stability union possible in which the debt to GDP ratios move in a zone in which market discipline can once again effectively constrain government indebtedness.

**Table 4**

<table>
<thead>
<tr>
<th>Country</th>
<th>Actual Primary Balance</th>
<th>Structural Primary Balance</th>
<th>Primary Balance Required to Meet Budget Rules</th>
<th>Primary Balance Required to Stabilize Current Debt Ratio</th>
<th>Improvement of Actual Primary Balance Required to Meet Budget Rules</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>%</td>
<td>% of GDP</td>
<td>with ERP</td>
<td>without ERP</td>
<td>with ERP percentage points</td>
</tr>
<tr>
<td>Germany</td>
<td>1.7</td>
<td>2.1</td>
<td>1.9</td>
<td>1.5</td>
<td>0.3</td>
</tr>
<tr>
<td>France</td>
<td>– 1.9</td>
<td>– 0.5</td>
<td>2.3</td>
<td>2.8</td>
<td>0.9</td>
</tr>
<tr>
<td>Italy</td>
<td>3.4</td>
<td>4.8</td>
<td>4.2</td>
<td>7.1</td>
<td>4.8</td>
</tr>
<tr>
<td>Spain</td>
<td>– 3.3</td>
<td>– 1.4</td>
<td>3.1</td>
<td>5.0</td>
<td>3.1</td>
</tr>
<tr>
<td>Netherlands</td>
<td>– 2.3</td>
<td>– 0.3</td>
<td>1.7</td>
<td>1.3</td>
<td>0.3</td>
</tr>
<tr>
<td>Belgium</td>
<td>0.4</td>
<td>1.1</td>
<td>2.8</td>
<td>4.0</td>
<td>2.0</td>
</tr>
<tr>
<td>Austria</td>
<td>– 0.3</td>
<td>– 0.0</td>
<td>2.1</td>
<td>2.3</td>
<td>0.7</td>
</tr>
<tr>
<td>Malta</td>
<td>0.8</td>
<td>0.8</td>
<td>2.7</td>
<td>3.2</td>
<td>1.8</td>
</tr>
</tbody>
</table>

1) European Redemption Pact. 2) Own calculations, source of basic data: EU, May 2012. 3) As a ratio of GDP in current prices. 4) As a ratio of potential GDP. 5) Maximum primary balance necessary to ensure deficit not exceeding 0.5% of GDP and national debt (not transferred to ERP) not exceeding 60% of GDP. Excluding ERP: Maximum primary balance needed to reach same evolution of debt ratio.
3 Legal considerations

40. A key criticism vis-à-vis the ERF relates to the limits of any solution to the European sovereign debt crisis set by European and constitutional law. Regarding the EU legal framework, the cleanest solution would be to change the Treaty on the Functioning of the European Union (TFEU), as a result of which the ERF could be introduced and would then interlink with valid EU law. However, in the course of policy-making to cope with the crisis, the EU legal framework has repeatedly been changed considerably. For example, Article 3 para 136 TFEU has been included in the Title on Economic and Monetary Policy and the interpretation of the existing Article 125 TFEU as a strict no-bail-out clause is controversial. The widespread opinion is that voluntary assistance to secure the stability of the Euro area is permissible. The new Article 136 para 3 TFEU can, in contrast, be understood to at any rate confirm this interpretation for cases where the assistance is permissible in “indispensable” cases of emergency and under strict terms (conditionality). It is conceivable that in the course of the change in the TFEU that is required any way, a corresponding clarification of the primary law is made or the ERF will be institutionally integrated into the ESM.

41. The ERF as proposed by the Council of Economic Experts can be structured in such a way that the needs of European and constitutional law are met. It should be established in order to guarantee the stability of EMU as a whole and restore confidence in the Euro area among citizens and investors alike. Thus, it constitutes a crisis mechanism that is, however, designed to also have a preemptive impact, not only because it makes credible consolidation policies possible in the first place, but moreover the member states participating are disciplined by the wide-ranging built-in safety measures. These include the fact that assistance is in principle subject to conditionality, penalty payments in the form of interest mark-ups, prescriptions on raising the funds to be repaid nationally (single-purpose tax increases) and even the tool of automatic retention of national currency reserves that can be pledged as collateral. In order to give the member states as reliable a guarantee as possible that their confidence in the future promise of mutual liability for the debt repayment, as is confirmed by the ERF, is indeed well-placed, the TFEU could include an explicit clause limiting the lifetime of the redemption fund.

42. Regarding an assessment of the ERF in light of constitutional law, the stipulations set by the German Basic Law as per the interpretation given in the afore-mentioned judgments by the German Constitutional Court shall apply (item 18 d). Thus, the standards set by constitutional law outline special requirements with regards to the limitation of the measures taken in time and in terms of the volume for which the Federal Republic of Germany shall be liable. Moreover, it must be guaranteed that in future German Parliament continues to exercise full control over its budget. The parliamentary right to decide in all budgetary matters could be eroded with a view to the financing volume covered by the ERF, which amounts to a multiple of the German budget, unless corresponding hedges are established. There is no evidence to suggest that the ERF could come up against the limits to political decision-making innate in constitutional law (Article 79 para 3 German Basic Law), especially concerning the free scope for action to be expected in the long term.
43. The principle right of German Parliament to refuse approval could be underpinned during the roll-in phase if the entire volume envisaged to be outsourced to the ERF in one year were defined in advance by German Parliament. This would render it unnecessary to (unrealistically) approve each individual refinancing decision by the fund within a budget year. Nevertheless, the German Parliament’s ability to take all decisions on budget policy would still need to be guaranteed.

44. Whether the ERF’s financing volume threatens to undermine budgetary policy-making powers depends in the end on the collateral guaranteed and the conditionality imposed. The German portion of the debt assigned to the ERF would need to be deducted from the expected total volume of almost € 2.6 trillion as the Federal Republic of Germany is liable for that sum anyway. The remaining volume may not simply be added to the “rescue plans” already implemented, including those of the ECB, because the redemption fund avoids taking up the funds still available under the rescue plans. The additional tying down of funds would, however, involve a clear expansion in conditionality and collateralization. The ERF would in fact feature some in-built positive automatisms that function (temporarily) in the sense of the assertion of budget policy-making rights called for by the German government. Thus, the undermining of parliamentary rights to resolve budget policy so problematic in terms of constitutional law would be avoided simply by the fund’s financial volume.

These safety measures and rights to intervene would, however, also tie the German legislature and restrict German Parliament’s budget policy-making powers. This need not be grasped as an impermissible limitation of Parliament’s democratic rights, however. Rather, these are freedom enabling obligations that exist on a large scale in any democratically governed state. The obligation incumbent upon German policy-makers to commit to credible consolidation would enable German Parliament in future legislative periods to take budgetary decisions without the strain of excessive interest expenses. Following the last amendments to the fiscal constitution, the German Basic Law is committed to consolidation of government finances. And in the form of the ERF a method would be created to tackle the up until now unsolved problems of existing debt. The higher interest payments Germany would incur due to the ERF when refinancing its existing debt are the actual price to be paid. Germany would therefore have to expect higher interest payments. At present, government budgets in Germany are already favoured by considerably lower interest payments resulting from Germany’s function as a safe haven. This interest advantage was spawned by the crisis itself and is thus to a certain extent artificial – and the ERF would correct this state of affairs. The interest level to be expected as a result would be quite justifiable and would not restrict policy-makers more than other changes to the financial parameters of government actions.
III Laying the foundations for a stable financial system

45. One of the central objectives of the Euro area summit on 29 June 2012 is to break the “vicious circle between banks and sovereigns” (summit statement by the members of the Euro area, 29 June 2012). The ESM shall be enabled to recapitalize banks directly, and a single supervisory mechanism involving the ECB shall be established. The corresponding proposals under supervisory law tabled by the European Commission shall be assessed by the European Council by the end of 2012. In Spain’s case, swift clarity is required on the actual details of the adjustment programme for the financial sector. Furthermore, concrete steps are planned to be taken in order to recapitalize Spanish banks. The ESM will not be given the status of senior creditor for the funds extended to Spain.

In order to assess the statement by the European Council, we shall firstly describe the state of the European banking industry. Secondly, we will elaborate on the cornerstones of a long-term regulatory framework and outline the key problems in the transition. In principle, the summit resolutions go into the right direction. However, delays of fundamental financial market reforms in the past are hindering short-term solutions to the Euro area debt crisis.

The European banking sector in crisis

46. Close linkages between banks and sovereigns, non-performing assets on banks’ balance sheets, and low levels of capitalization among many banks all indicate a high risk to the stability of the entire financial system. Should the crisis intensify in a few major banks that are “too big to fail”, then this can spill over onto other banks given the direct contractual linkages. There is also an indirect channel of contagion: If many banks are hit to a similar degree by shocks, then this can impact negatively on system stability.

Chart 8

Consolidated foreign claims of banks in selected countries against all BIS countries\(^1\)

in US Dollars billion

<table>
<thead>
<tr>
<th>Country</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>5,000</td>
<td>4,000</td>
<td>3,000</td>
<td>2,000</td>
</tr>
<tr>
<td>France</td>
<td>4,000</td>
<td>3,000</td>
<td>2,000</td>
<td>1,000</td>
</tr>
<tr>
<td>Spain</td>
<td>2,000</td>
<td>1,500</td>
<td>1,000</td>
<td>500</td>
</tr>
<tr>
<td>Portugal</td>
<td>1,000</td>
<td>1,500</td>
<td>2,000</td>
<td>2,500</td>
</tr>
<tr>
<td>Greece</td>
<td>500</td>
<td>1,000</td>
<td>1,500</td>
<td>2,000</td>
</tr>
<tr>
<td>Ireland</td>
<td>250</td>
<td>500</td>
<td>1,000</td>
<td>1,500</td>
</tr>
</tbody>
</table>

\(^1\) Countries reporting to the Bank for International Settlements (BIS): 21 June 2012.

Source: BIS
For example, if uncertainty rises, the financing situation of many banks could deteriorate overnight and compel them to shed assets. The resulting impact on asset prices could then hit other banks. This risk of European-wide contagion through the banking channel remains high, although banks of various member states of the Euro area have scaled back their direct loans to foreign countries (chart 8). In the countries in crisis, there is great financial sector uncertainty, as can be discerned from the volatility in bank share prices (chart 9).

47. The related risks are not restricted to the financial sector. Overall, the real economy in the distressed countries can stabilize only if there is a sound financial industry. Equally, any further stabilization of the financial sector depends on adequate growth. However, at present the interaction of the financial sector and the real economy is stuttering, as banks with non-performing assets have an incentive to roll over old loans in order to conceal balance sheet weaknesses (so-called forbearance). As a result, insufficient funds for new investments are being made available by the banks which slows down growth and sectoral change. Employees who lose their jobs will have difficulties in finding employment in other growing sectors.

These developments do not only affect individual countries. Due to foreign trade and financial linkages, they have a negative impact on the entire Euro area. The low confidence in banks in the distressed countries has caused private capital inflows to dry up or even reverse. Many banks in these countries are no longer able to refinance themselves through the private capital market and are strongly reliant on financing through the ECB (chart 10, left). The ECB has assisted the banks by lowering the standards for central-bank eligible collateral and by providing emergency liquidity assistance (ELA). All this is reflected in the sharp rise in TARGET2 balances within the Eurosystem (chart 10, right). All EMU member states are liable for the
risks that are thus shifted on to the central bank balance sheet – with the exception of the ELA loans for which the respective country is liable (AER 2011 item 135 and box 7). Negative externalities arising from distressed banks imply that other EMU member states are also interested in ensuring the enduring stability of the banks in the countries in crisis.

48. The **costs inflicted by financial crises on the real economy** may be considerable and depend primarily on the type of the crisis (AER 2011 box 15; Feenstra & Taylor, 2008). For instance a conjoint debt and currency crisis on average may last for up to five years, and the costs inflicted, measured as a deviation of actual GDP from the estimated GDP excluding the crisis amount to 10 per cent of GDP. Furthermore, the average duration of a conjoint debt and banking crisis is on average eight years, with costs of up to 13 per cent of GDP (De Paoli et al., 2006).

49. Hence, **stabilising the banking sector** should be a primary objective of policy-makers. However, policymakers are facing a dilemma. On the one hand, banking regulations should be tightened in the medium to long term, and banks should be required to hold higher levels of equity capital as a buffer against shocks. On the other hand, tightening regulations during a crisis could accelerate the crisis, in particular if banks are still burdened with a debt overhang from the past.

**A long-term regulatory framework for the European banking sector**

50. Many of the reforms currently being discussed at the European level and in particular the steps planned as part of a **banking union** are destined to create a new regulatory framework for European financial markets in the long-run. For example, the ECB calls for banking
supervision to be strengthened at the European level, a European deposit insurance system and the introduction of EU-wide regulations to overcome imbalances in the banking sector (ECB, 2012). The statement of the 29 June 2012 summit, which envisages in principle the possibility of banks’ direct recapitalization through the ESM, conditions this to the prior foundation of a single supervisory mechanism for the Euro area.

51. In earlier reports, the Council of Economic Experts specified the key cornerstones of a long-term regulatory framework for the European banking sector (AER 2009 items 196ff.). They include a central EU-wide banking supervision as well as regulations on restructuring and resolving banks. The European banking supervision should have sufficient information, effective powers of intervention and instruments enabling it to prevent erroneous developments or correct these developments pre-emptively. A European insolvency regime with a restructuring or resolving authority requires an adequate financial basis in order to be able to intervene swiftly and incisively in the event of a crisis. These resources should be established by a bank levy while a fiscal backstop, set up ex ante, is also needed. Unlike a comprehensive banking union, common deposit insurance is not a compelling component of the regulatory framework the Council of Economic Experts proposes.

52. Against the backdrop of a single monetary policy, two aspects speak in favour of a stronger centralization of supervisory, restructuring and winding-down capacities at the European level. First, supervision at the national level is potentially not able to act in sufficient independence from influential interest groups. Hence, incentives arise to shift risks to the European level. Not only the banks themselves have an incentive not to expose problems in their balance sheets; this incentive also exists among the national supervisors. If problems are revealed, supervisors implicitly have to admit to have made the wrong supervisory assessments.

A second reason for a stronger European centralization of supervisory, restructuring and winding down capacities derives from the fact that European financial markets are closely interconnected and that many banks are international players. If supervision is purely national in structure, cross-border financial inter-linkages and the related risks cannot be adequately identified.

53. However, it is unlikely that the extensive legal adjustments needed for such a standardization of supervisory and restructuring regimes can be implemented in the short term. Realization of the corresponding legal framework will require considerable time as can be shown by the proposal of a directive of the European Commission, concerning the standardization and strengthening of supervisory institutions, regarding their ability of prevention, intervention and winding up in case of problems in the European banking sector (European Commission, 2012). The directive is meant to ensure that all national supervisory and liquidation authorities have a uniform minimum set of crisis prevention and intervention instruments. The Commission itself does not expect the regulations to be implemented before 2015, and it considers the directive to be merely a first step.
54. The steps toward a new regulatory framework for the European financial markets and the necessary legal amendments thus need a lot of time. In particular, transferring supervisory functions requires the cession of sovereign rights. On the one hand, the fact that little progress has to date been made in these areas blocks short-term solutions to solve the difficulties in the banking sector. On the other hand, banking recapitalization and restructuring cannot wait until all open regulatory issues have been settled. Setting the right priorities is thus all the more important.

Since the beginning of the financial crisis, a series of changes regarding financial market regulations have been initiated. Yet, priorities should have been set differently. Instead of focussing on introducing a financial transactions tax, the pressing goal for policy makers should have been to create a legal framework that sets the right incentives for the banking sector, reduces the probability of systemic crises and enables better crisis management. The steps taken to date are insufficient and a lot of time has already been lost.

55. In the course of the debate on a European banking union there has also been discussion on the need for a European deposit insurance system. However, deposit insurance cannot be the answer to the low degree of capitalization of many European banks. For the immediate introduction of a European deposit insurance system would be equivalent to concluding an insurance taken out after the damage it insures against has already happened. Essentially, a European deposit insurance system is conceivable only once the long-term regulation framework is fully in place and the supervisory and restructuring institutions have been furnished with sufficient powers of intervention.

These conditions must be met as deposit insurance (like any other insurance) entails the risk of misbehaviour due to distorted incentives. Badly designed deposit insurance systems do not lower risks in the banking system but can instead intensify them. Therefore, a fairly-priced insurance fee would be needed in order to reduce risk-taking incentives. If insurance is not properly priced, then deposit insurance at the European level could become a transfer mechanism and essentially increase the incentive to take on debt.

56. Irrespective of the actual form a banking union takes, cross-border insurance mechanisms for banks should only be introduced if corresponding European level supervisory competences and powers of intervention are established. Joint liability requires joint control. As crucial as steps in this direction are, a banking union should not be seen as a solution to short-term problems. Instead, an approach which is implemented too quickly could lead into the wrong direction due to the urgency of the current crisis. In short, realizing a banking union under time pressures involves risks. Thus short-term solutions must now be found to enable the necessary bank recapitalization on the basis of clearly defined principles and in the current institutional framework. Moreover, one has to make sure that the right foundations for a new institutional regime in the future are laid.
Principles for government recapitalization of banks

57. Addressing acute instabilities in the banking system may require taking measures before the details of a new institutional framework for financial markets have been decided upon. Spain currently faces such a problem, and it has already filed an application to the EFSF for financing to recapitalize its banks. In order to use such funds effectively, it is important to define key objectives for crisis resolution. Here, the focus must be on effectively using the available funds and preventing any short-term crisis resolution blocking the past to the long-term regulatory framework.

Short-term stabilization must focus on raising capital levels of banks. **Higher bank capital** not only renders the individual bank more stable and thus reduces the risk of failure; higher bank capital also lowers the large multipliers and leverage effects that can lead to systemic crises. Market trends after the Lehman Brothers bankruptcy showed that relatively small shocks to the financial system can have large systemic effects if many banks have to adjust to the shock at the same time and in the same way.

58. Japan’s experiences are a prime example of the **wrong incentives that a delayed recapitalization and restructuring of banks** can have on the real economy. In the 1990s and early 2000s, being poorly capitalized, Japanese banks rolled over non-performing loans and expanded existing credit lines, thus sustaining business models in the real economy that were not viable (Caballero et al., 2008; Peek & Rosengren, 2005). To avoid a “Japanese scenario”, distressed banks should therefore be swiftly and decisively recapitalized and restructured. Experiences in previous banking crises show that the following criteria should apply for successful bank recapitalization and restructuring (Hoshi & Kashyap, 2010; BMWi Beirat, 2008):

(1) The banks must be thoroughly audited to identify the **capital shortfall**. In a crisis, there is an incentive for banks to systematically underestimate risks and to exploit the scope for accounting discretion (AER 2009 item 263; Huizinga & Laeven, 2009). Stress tests such as those conducted by the European Banking Authority (EBA) in autumn 2011 typically do not uncover the entire extent of write-downs needed. In the current institutional framework, the capital shortfall can be determined through detailed audits involving the EBA in cooperation with the national supervisors and external experts.

(2) If possible, banks should raise the capital required in the markets or internally through retained earnings. However, in a crisis, it is precisely these adjustment channels that are blocked. If one were to force the banks to fulfil higher capital requirements in a crisis, one would also force them to achieve part of the adjustment by shedding assets. This deleveraging can in turn intensify the crisis. Also, due to negative signalling effects and the threat of outside control of bank management, banks do not voluntarily take up government capital, hence, **compulsory recapitalization** may become necessary.
(3) If additional financial resources are made available by the government, then it must be ensured that the government also assumes control rights to a sufficient extent. Merely extending guarantees, buying assets, or assigning distressed assets to a Bad Bank do not fulfil these conditions as this does not entail changes in control or ownership structures.

(4) For recapitalization through the government to be successful, banks must be effectively restored to financial health and restructured. This can result in a significant downsizing of activities or even resolution of those banks that have no sustainable business model. Currently, an effective resolution and insolvency procedure for banks is lacking at the European level though.

59. Recapitalization of banks through public funds should not lead to government ownership of banks in the long term. The opposite is the case: recapitalization through the government should seek to enable the banks to regain health as quickly as possible, to reduce costs for taxpayers and to restore a functioning banking industry by re-privatizing the banks (BMWi Beirat, 2008).

What is to be done

60. These general considerations have implications for the use of recapitalization funds provided by the EFSF or the ESM. In general, the goal should be to enhance the stability of European banking systems and to prevent the need for crisis resolution mechanisms and bank recapitalization using public funds.

61. Incentives to procrastinate problems in the banking industry may emerge at the level of individual banks, national supervisors, or the government. Banks have incentives to delay recapitalization because such support measures may be linked to restructuring of the distressed banks. Hence, control rights of the banks’ management and owners may be constrained. Governments, in turns, do not have incentives to apply for recapitalization funds from the EFSF or ESM because such application could be construed as a negative sign and thus threaten the viability of public finances in that country as a whole. Spain can serve as a good example here, as the government decided only under external pressure that it would apply for EFSF funds to recapitalize its banks.

In order to counter this problem of (regulatory) forbearance, the EBA or the ECB should exert enough pressure to ensure the problems are tackled at the level of the individual banks. However, according to the existing rules, the EBA can go into action only by making recommendations to the national supervisors. Neither the EBA nor the ECB possess direct supervisory or restructuring power. One might therefore consider whether the EBA should be vested with the additional power to issue a public warning to governments or banks and thus to exert pressure. At the same time, it must be considered that public warnings can boost uncertainty among market players. The ECB could take an active role by tightening its requirements as regards the criteria banks have to meet to refinance themselves through the central bank. However, this would mean that the ECB has access to the relevant supervisory data on the status of the banks concerned, contrary to current practice.
62. At the same time, public financial resources are needed if undercapitalized banks should not be able to raise fresh capital in the markets or by retaining profits and if the country concerned cannot put up the capital by itself. The EFSF or the ESM thus in principle offer an avenue for making **financial assistance for recapitalization** available. According to Article 15, the ESM can provide loans to the respective government that can be used to recapitalize financial institutions. These loans are not directly extended to the banks but to the country concerned, which then guarantees repayment. Countries that qualify for such support must sign a memorandum of understanding which emphasizes financial sector restructuring. This memorandum should meet the above-mentioned criteria and in particular contain conditions for the restructuring and, if necessary, a winding-up of the banks in question.

63. Spain has already applied to the EFSF for funds to recapitalize its banks. According to the above criteria for recapitalization, detailed audits involving external experts have been initiated in order to specify the capital shortfall. On this basis, a recapitalization plan should be defined for the level of capital required by the individual banks, not only the ratio of capital to (risk-weighted) assets. The goal should be to prevent a process of deleveraging while, at the same time there must be sufficient scope for the restructuring of balance sheets as becomes necessary.

64. If the EFSF or the ESM furnishes public financial resources for recapitalization then this constitutes a considerable **competitive advantage** for the banks concerned. In addition, banks with significant public ownership may engage in politically motivated lending practices. Hence, banks which receive financial support should be supervised by a politically independent European institution. In the present institutional framework, the EBA or the ECB would be the obvious choices. Close cooperation with the European competition authority is also imperative. It should be the task of the competition authorities to impose strict conditionality on the respective banks such as partial asset sales, and to develop and enforce clear exit strategies for state participations in banks.

During the transition to a full-fledged European regime for supervision, restructuring and winding-up banks, certain **competences and powers of intervention** could be assigned to an existing European institution. This institution could then exercise the necessary supervisory function and monitor restructuring. In other words, the country in question would take up a loan from the EFSF or ESM assume a stake in the equity capital of the respective banks, and then assign the voting rights to the EFSF or the ESM. Since the latter two at present neither have the functional nor personnel resources to execute supervisory duties in banks, the operative functions of restructuring and restoring banks to financial health would need to be carried out by national supervisors in cooperation with a European institution. Here, one could opt either for the EBA or the ECB. To the extent that the ECB is involved, its monetary-policy and supervisory functions are to be kept duly separate. However, it is important to bear in mind that any short-run policy measures to be taken should not block the way to a consistent regulatory structure for the future.
65. In light of recent experiences with Spain, there has also been discussion as to whether the funds to recapitalize banks should be allocated directly to the country, as is currently envisaged in the Treaty Establishing the ESM, or instead could accrue directly to the banks, as is supposed to be possible in the future under certain conditions, following the 29 June 2012 summit resolutions. Giving EFSF or ESM funds for bank recapitalization to the country in question has the potential disadvantage of increasing the public debt to GDP ratio and thus raising the costs of refinancing.

In line with the principle of guaranteeing the **unity of liability and control**, the heads of state and government in the EMU have resolved to make this path firmly dependent on first establishing a European supervisory agency. The very fact that establishing such an institution will require much time would indicate that this alternative approach will not come to bear in the short term. Moreover, it does not suffice, as the reference to Article 127 para 6 TFEU suggests, merely to delegate supervisory authority to a European body. Rather, this body must also have powers to restructure and wind-up banks if recapitalization funds would be granted directly to the banks and the country in question would no longer be directly liable.

**Summary**

66. The European banking and financial sector is in an acute crisis that calls for swift action by policy makers. At the same time, delayed financial sector reforms are now hampering crisis management. Essentially, the statement of the 29 June 2012 summit rightly focuses on the inter-linkages between banks and sovereigns. What will be decisive are the concrete measures to be taken and the speed with which the necessary reforms are implemented. In the opinion of the Council of Economic Experts, policy makers should take their cue from a **Three Point Plan** that contains the following elements:

1. **Acute crisis management**

67. A solution to the problems in the Spanish banking sector cannot wait until a long-term regulatory framework for the European banking system has been established. That said we need clarity as quickly as possible on how the funding Spain has applied for will actually be used to recapitalize banks. The focus must be on avoiding the mistakes of past crises. Recapitalization and restructuring must follow **clear criteria**: On the basis of a thorough audit of banks’ balance sheets with the assistance of outside experts, banks’ capital requirements should first be defined. Only if these cannot be covered from private or national sources should EFSF or ESM loans be granted to the member state, which then proceeds to use public funds to recapitalize the banks. In any case, the government should provide additional equity capital, and it should assume the associated control functions. The goal must be to restructure banks in such a way that they in future have sustainable business models. It will be necessary to closely involve European institutions and specifically the European competition authority in the process.

68. In order to reduce the scope for delayed solutions to banking sector problems and for forbearance, the ECB should be granted improved **access to supervisory information** such
as to enable it to judge the status of banks. It can then link the terms for refinancing operations to the soundness of the bank in question and in this way pressurize national supervisors into tackling banking sector problems at an early stage.

Should it be necessary to resort to the ESM to recapitalize banks, then this should initially only be effected via the state in question. The conditions stipulated in the 29 June 2012 statement by the EMU heads of state and government allow for direct recapitalization to banks only if a European supervisory mechanism has been established. This is unlikely to be met in the foreseeable future. Moreover, supervision at the European level does not in itself suffice. Instead, powers of restructuring and resolution must also be transferred to a European-level body.

2 Make up for lost time

69. In the long term, an effective supervisor at the European level should ensure that the probability and the scale of crises decline. Higher bank capital will play a key role in this context because this will enhance their ability to bear risk. Parallel to this, mechanisms for restructuring and winding-up banks need to be established. Should it be necessary to use common financial resources to restructure banks, then common supervisory and resolution mechanisms have to be implemented.

70. More than four years have passed since the financial crisis broke out, and during this time key European reforms for the financial markets have been discussed intensively. However only a few have been initiated. Coherent implementation is still missing. At present, finding a comprehensive solution to the European debt crisis is complicated by the absence of effective and European-wide procedures for restructuring and winding-up banks, in particular large credit institutions that have cross-border activities. Priority should therefore be given to reforms in these areas.

3 No overhasty moves toward a banking union

71. Establishing a banking union will take a considerable amount of time. Key issues to be clarified include the location and tasks of the banking supervisor, the introduction of uniform processes for winding-up and restructuring banks, deposit insurance, and not least the attendant financing questions. A long-term system in which liability and supervision are in one and the same pair of hands requires not least that national sovereignty is partly given up. This will invariably take some time; it is therefore all the more important that progress is made now on introducing the regulatory changes required.
Bibliography


