LIFE IN THE EUROZONE WITH OR WITHOUT

SOVEREIGN DEFAULT?

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EDITED BY
Franklin Allen
Elena Carletti
Giancarlo Corsetti

With a foreword by
Josep Borrell Fontelles

AUTHORS
Edmond Alphandéry
Arnoud W.A. Boot
Lee C. Buchheit
Charles W. Calomiris
Youssef Cassis
Mitu Gulati
Martin Hellwig
Janet Kersnar
Ramon Marimon
Wolfgang Münchau
Erik F. Nielsen
Fabio Panetta
Helmut Siekmann
David A. Skeel, Jr.
Karl Whelan

European University Institute
Florence, Italy
and
Wharton Financial Institutions Center
University of Pennsylvania, Philadelphia, USA

Published by FIC Press
Wharton Financial Institutions Center
2405 Steinberg Hall - Dietrich Hall
3620 Locust Walk
Philadelphia, PA 19104-6367
USA

First Published 2011

ISBN 978-0-9836469-1-4 (e-book version)

Cover artwork, design and layout by Christopher Trollen

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The Contributors

Franklin Allen
University of Pennsylvania
Franklin Allen is the Nippon Life Professor of Finance and Professor of Economics at the Wharton School of the University of Pennsylvania. He has been on the faculty since 1980. He is currently Co-Director of the Wharton Financial Institutions Center. He was formerly Vice Dean and Director of Wharton Doctoral Programs and Executive Editor of the Review of Financial Studies, one of the leading academic finance journals. He is a past President of the American Finance Association, the Western Finance Association, the Society for Financial Studies, and the Financial Intermediation Research Society, and a Fellow of the Econometric Society. He received his doctorate from Oxford University. Dr. Allen's main areas of interest are corporate finance, asset pricing, financial innovation, comparative financial systems, and financial crises. He is a co-author with Richard Brealey and Stewart Myers of the eighth through tenth editions of the textbook Principles of Corporate Finance.

Edmond Alphandéry
CNP Assurances
Edmond Alphandéry has served as Chairman of CNP Assurances in Paris since 1998. Prior to this appointment he was Chairman of Electricité de France. From 1993-1995 he worked as a Minister of the Economy in the Government of Edouard Balladur, where he launched a widespread program of privatization, including BNP, Elf, and Renault. Mr. Alphandéry graduated in 1966 from Institut d'Etudes Politiques de Paris, and after studying at the University

of Chicago and the University of California, Berkeley, he obtained his French Ph.D. in Economics in 1969 and his "Agrégation" in Political Economy in 1971. He began his university career at the University of Nantes and from 1974-1992 served as a Professor of Political Economy at the University of Paris II. As former Member of the Consultative Committee of RWE AG, Mr. Alphandéry is presently a Board Member of Crédit Agricole CIB, of GDF SUEZ and of ICADE. He also attends the Consultative Committee of the Banque de France and belongs to the French section of the "Trilateral Commission." He is the author of numerous articles and books devoted to economic and monetary affairs, as well as the founder of the "Euro50 Group" which gathers leading European personalities concerned with monetary policy of the European Central Bank.

Arnoud W.A. Boot
University of Amsterdam
Arnoud Boot is Professor of Corporate Finance and Financial Markets at the University of Amsterdam and director of the Amsterdam Center for Law & Economics (ACLE). He is a member of the Dutch Social Economic Council (SER) and the Bank Council of the Dutch Central Bank (DNB). He is also Research Fellow at the Centre for Economic Policy Research (CEPR) in London and at the Davidson Institute of the University of Michigan. Prior to his current positions, he was on the faculty of the J.L. Kellogg Graduate School of Management at Northwestern University in Chicago, and during 2000-2001 he was a partner in the Finance and Strategy Practice at McKinsey & Co. Arnoud Boot is member of the Royal Netherlands Academy of Arts and Sciences (KNAW). Arnoud Boot held visiting appointments at several universities. He has been Bertil Danielsson Visiting Professor at the Stockholm School of Economics in Sweden and Olin Fellow at Cornell University in the U.S., and is also conferred the honorary title of visiting professor from the Faculty of Economics of the University of Ljubljana. His research focuses on corporate finance and financial institutions. He has written on regulation of financial institutions, the design of securities, corporate governance, capital structure, corporate divestitures and take-overs and rescheduling of sovereign debt. His publications have appeared in major academic journals, such as the Journal of Finance, Ameri-

can Economic Review, Economic Journal and the International Economic Review

Josep Borrell Fontelles
President of the European University Institute
Josep Borrell graduated in Aeronautical Engineering 1969 and obtained his PhD in Economic Sciences in 1976. From 1983 he was Professor in Economic Analysis at Complutense University of Madrid. From 1984 to 1991 he was Spanish Secretary of State for Finance, and from 1991 – 1996 he was Spanish Minister for Public Works, Transport, Environment, Housing and Telecommunications. In 1999 – 2004 he was President of the European Affairs Committee of the Spanish Parliament (and from 2002 – 2003 Member of the European Convention). In 2004 he was elected President of the European Parliament, a position which he covered until 2007. From 2007 he was President of the Development Committee of the European Parliament and in 2010 he began his mandate as President of the European University Institute.

Lee C. Buchheit
Cleary Gottlieb Steen & Hamilton LLP
Lee Buchheit is a senior partner in the Sovereign Practice Group at Cleary Gottlieb Steen & Hamilton LLP, based in New York. He regularly advises sovereign borrowers on their debt management activities. Mr. Buchheit has worked on the debt restructurings of Mexico, the Philippines, Guatemala, Ecuador, Russia, Liberia, Tanzania, Belize, Grenada, Dominica, Uruguay, Jamaica, Nigeria and Iraq, among others.

Charles W. Calomiris
Columbia University
Charles W. Calomiris is the Henry Kaufman Professor of Financial Institutions at Columbia Business School and a Professor at Columbia's School of International and Public Affairs. His research and teaching span several areas, including banking, corporate finance, financial history, and monetary economics. He received a B.A. in economics from Yale University in 1979 and a Ph.D. in economics from Stanford University in 1985. Professor Calomiris is the author

of many books and academic articles, as well as numerous public policy articles, op-eds, and Congressional testimonies.

Elena Carletti

European University Institute

Elena Carletti is Professor of Economics at the European University Institute, where she holds a joint chair in the Economics Department and the Robert Schuman Centre for Advanced Studies. She is also Research Fellow at CEPR, Extramural fellow at TILEC, Fellow at the Center for Financial Studies and at the Wharton Financial Institutions Center. Her main areas of interest are financial intermediation, financial crises, financial regulation, corporate governance, industrial organization and competition policy. She has published numerous articles in leading economic journals, and has recently coedited a book with Franklin Allen, Jan Pieter Krahnen and Marcel Tyrell on Liquidity and Crises. She has worked as consultant for the OECD and the World Bank and participates regularly in policy debates and roundtables at central banks and international organizations.

Youssef Cassis

European University Institute

Youssef Cassis is professor of economic history at the European University Institute, in Florence. He was Professor of Economic and Social History at the University of Geneva, Switzerland (2004-2011) and Professor of International Economic History at the University Pierre Mendes France in Grenoble, France (1997-2004). He also held a long-standing research fellowship at the London School of Economics and has been a visiting professor at the Graduate Institute for International and Development Studies in Geneva, the Cass Business School in London, and the University of St. Gallen. His work mainly focuses on banking and financial history, as well as business history more generally. His most recent books include Capitals of Capital: A History of International Financial Centres, 1780-2005 (Cambridge University Press, 2006, 2nd revised edition 2010), and Crises and Opportunities: The Shaping of Modern Finance (Oxford University Press, 2011).

Giancarlo Corsetti

University of Cambridge

Giancarlo Corsetti (Ph.D. Yale, 1992) is Professor of Macroeconomics at Cambridge University. He has taught at the European University Institute in Florence, Rome III, Yale University and the University of Bologna. He is co-director of the International Macroeconomic Programme at CEPR, and of the Pierre Werner Chair Programme on Monetary Unions at the Robert Schuman Centre for Advanced Studies at the EUI. A consultant of the Directorate-General for Research at the European Central Bank, he is also a regular visiting professor in central banks and international financial and monetary institutions, and a member of the European Economic Advisory Group at CESifo. Now a member of the Council of the European Economic Association, in 2007 he has served as Program Chairman of the association's Annual Congress in Budapest. His main fields of interest are international economics and open-economy macroeconomics with contributions covering a wide range of theoretical and policy issues: currency and financial crises, international transmission mechanisms, monetary and fiscal policy, and global imbalances. He is currently co-editor of the Journal of International Economics and the International Journal of Central Banking.

Mitu Gulati

Duke Law School

Mitu Gulati is on the faculty at the Duke Law School. He does research on the design of restructuring mechanisms for sovereign debtors and the historical evolution of contract terms in sovereign bond agreements. He was previously on the faculty at UCLA Law School.

Martin Hellwig

Max Planck Institute for Research on Collective Goods

Martin Hellwig is a Director at the Max Planck Institute for Research on Collective Goods and Professor of Economics of the University of Bonn, Germany. He holds a doctorate in economics from the Massachusetts Institute of Technology. He has held university positions at Stanford, Princeton, Bonn, Basel, Harvard, and Mannheim. His research interests involve public economics, financial institutions, and competition policy. He is a Member of the Academic Advisory

Committee of the German Ministry of the Economy and Technology and of the European Commission's Economic Advisory Group on Competition Policy, a Past Chairman of the German Monopolies Commission and of the German Government's Advisory Committee of Wirtschaftsfonds Deutschland. From May 1, 2011, he is also Chairman of the Advisory Scientific Committee of the European Systemic Risk Board.

Janet Kersnar

Knowledge@Wharton

Janet Kersnar is the London-based European Editor of Knowledge@Wharton. Before joining the K@W team in 2009, Janet was Editor-in-Chief for 11 years of CFO Europe, which was part of a global portfolio of award-winning magazines for chief financial officers published by The Economist Group. Prior to that, she had been an Editor at The Wall Street Journal and other Dow Jones International publications, along with various other publishing work that's in Paris, Berlin and San Francisco.

Ramon Marimon

European University Institute and Barcelona GSE – UPF

Ramon Marimon (Northwestern University PhD, 1984) is Director of the Max Weber Postdoctoral Programme and Professor of Economics of the European University Institute, Chair of the Barcelona Graduate School of Economics, Professor of the Universitat Pompeu Fabra (UPF) and Associate Researcher of CREi (on leave). Chair of the European Economic Association Standing Committee on Research. Research fellow of CEPR and NBER. Former assistant and associate professor at the University of Minnesota, Secretary of State for Science and Technology of the Government of Spain (2000-2002) and president of the Spanish Economic Association (2004). Co-founder of UPF as Dean and Chair of Economics and Business (1990-1991), and founder and director of the Centre de Recerca en Economia Internacional (CREi, 1994). He has been advisor of the European Commission on R&D policy. His research interests include Macroeconomics, Monetary Theory, Contract Theory, Learning Theory, Labor Theory, and the Economics of Science and Innovation. He has published in Econometrica, Journal of Political

Economy, American Economic Review, Journal of Economic Theory, Review of Economic Dynamics, and others.

Wolfgang Münchau

Eurointelligence

Wolfgang Münchau, 48, is associate editor and European economic columnist of the Financial Times. Together with his wife, the economist Susanne Mundschenk, he runs eurointelligence.com, an internet service that provides daily comment and analysis of the euro area, targeted at investors, academics and policy makers. Wolfgang was one of the founding members of Financial Times Deutschland, the German language business daily, where he served as deputy editor from 1999 until 2001, and as editor-in-chief from 2001 until 2003. FT Deutschland is now a firmly established player in the German media market with a daily circulation of more than 100,000 copies sold. Previous appointments included correspondent posts for the Financial Times and the Times of London in Washington, Brussels and Frankfurt. He was awarded the Wincott Young Financial Journalist of the Year award in 1989. He holds the degrees of Dipl-Betriebswirt (Reutlingen), Dipl-Mathematiker (Hagen), and MA in International Journalism (City University, London). Wolfgang has published three German-language books. His book Vorbeben, on the financial crisis, has received the prestigious GetAbstract business book award in 2008, and is now published by McGraw Hill in the US. Wolfgang and Susanne live in Brussels with their sons Joshua and Elias.

Erik F. Nielsen

Former European Chief Economist, Goldman Sachs

Erik F. Nielsen is appointed Global Chief Economist at Unicredit, effective September 1, 2011. He spent the previous 15 years at Goldman Sachs, most recently as Chief European Economist. Before joining Goldman Sachs, Erik spent about ten years in Washington DC working for the World Bank and the IMF on Russia, Europe and global debt issues. Before that he was an economist at the Danish central bank, and he taught for two years at the Copenhagen Business School. He holds a graduate degree in economics from the University of Copenhagen.

Fabio Panetta

Bank of Italy

Fabio Panetta is Managing Director of the Bank of Italy. He holds a degree in economics from the University of Rome, a Master of Science in monetary economics from the London School of Economics and a Ph.D. in financial economics from the London Business School. Dr. Panetta is a member of the G-10 Governors' Committee on the Global Financial System and a member of the Management Committee of the International Journal of Central Banking. He participates to the meetings of the Governing Council of the European Central Bank as Accompanying Person to the Governor of the Banca d'Italia. His research has been published in academic journals, including The American Economic Review, The Journal of Finance, the European Economic Review, the Journal of Banking and Finance, and the Journal of Money, Credit and Banking.

Helmut Siekmann

University of Frankfurt

After receiving his doctor juris and his post-doctoral degree ("Habilitation") from the Law School of the University of Cologne, Professor Siekmann was tenured professor of public law at the Ruhr University Bochum. Since summer 2006, he is professor of money, currency and central-bank law at the University of Frankfurt and director of the Institute for Monetary and Financial Stability. Professor Siekmann holds also a degree in economics ("Diplom-Volkswirt") from the University of Bonn and a doctor honoris causa from the Univerité Paris-Dauphine. Professor Siekmann's research focuses on all aspects of government finances, including separate entities (enterprises) under government control; the institutional framework for the European System of Central Banks; the role of central banks and their legal foundations; as well as the supervision of financial markets. He has published intensively on a wide variety of topics, with an emphasis on the financial aspects of a subject matter.

Professor Siekmann gained intensive international experience as visiting scholar at the U.C. at Berkeley (1985), and as visiting professor at the St. Louis University in St. Louis, Missouri, USA (1996, 1999, 2001), at the Université d'Orléans, France (2003, 2004, 2005, 2006), the Université Paris-Dauphine (2005, 2007), and the Univer-

sité de Luxembourg (2009).
Professor Siekmann participated in the drafting of statutes and served as expert witness for high ranking government organs and in legislative procedures on federal and state levels. He has represented constitutional bodies in several constitutional court cases.

David Skeel
University of Pennsylvania Law School
David Skeel is the S. Samuel Arsht Professor of Corporate Law at the University of Pennsylvania Law School. He is the author of The New Financial Deal (Wiley, 2011); Icarus in the Boardroom: The Fundamental Flaws in Corporate America and Where They Came From (Oxford, 2005) and Debt's Dominion: A History of Bankruptcy Law in America (Princeton, 2001), as well as "Redesigning the International Lender of Last Resort," Chicago Journal of International Law (2005)(with Patrick Bolton) and other articles on sovereign debt, bankruptcy, and corporate law. He also has written commentaries for the New York Times, Wall Street Journal, Weekly Standard and other publications.

Karl Whelan
University College Dublin
Karl Whelan has been a Professor of Economics at University College Dublin since 2007. He obtained his PhD from MIT in 1997 and worked for ten years in central banks, first at the Federal Reserve Board in Washington and then at the Central Bank of Ireland. His research is generally concentrated in applied macroeconomics and has been published in journals such as the American Economic Review, Review of Economics and Statistics, Journal of Monetary Economics, and Journal of Money, Credit, and Banking. Prof. Whelan is currently a member of the Monetary Experts Panel that advises the European Parliament's Committee on Economic and Monetary Affairs. He also blogs on Irish economic issues at www.irisheconomy.ie.

Acknowledgments

Our thanks go to all the people and institutions that have helped make the conference and this book possible. We are particularly grateful to Christopher Trollen, Patricio Valenzuela, Julia Valerio and the Presidential Office at the European University Institute. This book is produced as part of the project 'Politics, Economics and Global Governance: The European Dimensions' (PEGGED) funded by the European Commission under its Seventh Framework Programme for Research (Collaborative Project), Contract no. 217559. We would also like to thank the Sloan Foundation grant to the Wharton Financial Institutions Center for financial support.

FOREWORD

It is with great pleasure that I write a short foreword to this e-book "Life in the Eurozone: With or Without Sovereign Default". Remembering that the Convention of the European University Institute (EUI) stipulates that our institution should do research on "the major issues confronting contemporary European society, including matters relating to the construction of Europe", this e-book certainly perfectly contributes to the EUI's mission. The sovereign debt crisis and its implications, which we are witnessing in Europe, are a major challenge to European society and have severe impacts on the broader European integration process. The publication of the e-book comes at a very timely moment and the individual chapters cover topics that currently dominate the political, economic and academic discussion in and on Europe.

I would like to begin by thanking and congratulating the editors of this e-book. When Professors Elena Carletti, Franklin Allen and Giancarlo Corsetti held the workshop "Life in the Eurozone: With or Without Default" in April 2011 at the EUI, it was my pleasure to attend this event and to follow the presentations and discussions. The workshop, which was held in the framework of the PEGGED project (Politics, Economics and Global Governance: The European Dimensions) and which was co-organised with the Wharton Financial Institutions Center, was of outstanding quality and it is with pleasure that I see the workshop's presentations and results being published in this e-book.

At the time of writing this foreword (May 2011), European policy-makers are discussing whether the currently agreed multi-billion euro bailout loan package for troubled Greece is sufficient or whether it needs to be extended. Since the European sovereign debt crisis fully emerged roughly a year ago, we have witnessed a period with dramatic scenarios, economic and financial shocks, numerous meetings and negotiations and far-reaching changes to the Euro system. Eventually, the Eurozone heads of state and the EU political machine announced during their Council at the end of March that a solid solution to tackle the current and future crises has been adopted.

However, while many important changes in the economic governance of the euro and regarding bail-out mechanisms have been made, we still seem far away from reaching a proper solution. Furthermore, with now Ireland and Portugal receiving bailout packages as well, the European heads of state are struggling to convince their doubting parliaments and their very sceptical electorates about the decisions taken and the reforms initiated. Apart from issues of sovereign debt and the handling of a monetary union, the current crisis seems to have put the broader process of the European integration project into question.

While there is no place in this foreword to reflect on the reasons for this, many economists and media rightly accuse the European leaders, who claim to have obtained a 'successful grand bargain', of again dangerously 'muddling through' and 'just kicking the can down the road'. One of the biggest problems in the political management of the crisis is a total avoidance of considering debt restructuring and sovereign default. While there might be strong political reasons for this, an increasing number of experts in economics, finance, politics and the media claim that – above all in the case of Greece – there is no way out of the crisis without the restructuring of debt.

The main contribution of this e-book is that it discusses what such a restructuring could look like. Underlining that a Greek default seems to be increasingly unavoidable, the e-book reflects on possible 'end-game scenarios' in which Greece restructures its debt. Leaving political questions aside, the authors highlight financial and economic

perspectives and refer to historical experiences and lessons learnt. The option of Greece and other countries leaving the Eurozone, which is publicly ruled out by European politicians, is also discussed and scenarios of a fundamentally changed Eurozone are presented.

Overall, I am convinced that this e-book will be very stimulating for its readers and it will make a major contribution to the ongoing political and academic debate.

Josep Borrell Fontelles

President of the European University Institute

PREFACE

The European University Institute (EUI) and the Wharton Financial Institution Center (FIC) organized a conference entitled "Life in the Eurozone With or Without Sovereign Default?" The event, which was held at the EUI in Florence, Italy, on 14 April 2011, was financed by the PEGGED project (Politics, Economics and Global Governance: The European Dimension) and a Sloan Foundation grant to the FIC. The conference brought together leading economists, historians, lawyers and policy makers to discuss the current economic situation in the Eurozone with particular emphasis on the issue of sovereign default. The aim was to have an open discussion on this timely and important topic to achieve a better understanding of the future development of the Eurozone.

The event was opened by the President of the European University Institute, Josep Borrell. It consisted of three panels, a keynote speech and a dinner speech. The topic of the first panel was The Current Situation. Ramon Marimon (European University Institute) provided an analysis of the P.I.G.S. (Portugal, Ireland, Greece and Spain) with particular emphasis on Spain and Portugal. Fabio Panetta (Bank of Italy) described the various responses of the European Central Bank (ECB) and other policy entities in the different phases of the crisis. Helmut Siekmann (University of Frankfurt) discussed the legal framework underlying the European monetary union and the limits posed by the German constitution. Karl Whelan (University College Dublin) described the Irish situation stressing the consequences

of the burst of the real estate bubble in 2007 on unemployment, growth and other economic indicators.

In the keynote address on Quo Vadis, Euroland? European Monetary Union between Crisis and Reform, Martin Hellwig (Max Planck Institute for Collective Goods) argued that the Eurocrisis consists of three separate dimensions: a fiscal crisis in Greece and Portugal, a banking crisis in Ireland and banking problems in countries like Germany or France with large exposure to the problematic sovereign and bank debt. He stressed the difficulty of finding solutions to the current problems and at the same the need to arrange for a credible system of governance after 2013.

The second panel discussed in more detail How would Eurozone Sovereign Bankruptcy Work? Arnoud Boot (University of Amsterdam) described the consequences of sovereign restructuring for financial stability in particular in light of the size and complexity of modern financial institutions. Lee C. Buchheit (Clearly Gottlieb Steen & Hamilton LLP) and Mitu Gulati (Duke University) made a joint presentation explaining the possible "endgame scenarios" for Greek debt restructuring before or after 2013. David Skeel (University of Pennsylvania) described how a sovereign bankruptcy system might work.

The third panel considered Alternatives to Sovereign Bankruptcy including the possibility for troubled countries to leave the euro area. Edmond Alphandéry (CNP Assurances) discussed the sustainability of the current policy measures and concluded that they may well be successful. Charles Calomiris (Columbia University) took the opposite view and expressed deep scepticism about the survival of the Eurozone in its current form. Youssef Cassis (European University Institute) focused on the comparison of the current situation with historical precedents. Erik Nielsen (Formerly Goldman Sachs) took a more moderate position on the sustainability of the Eurozone arguing that, while there were problems, it would survive.

At dinner, Wolfgang Munchau (Eurointelligence) presented his view on How the EU Wants to Solve the Crisis – and Why this is Not

Going to Work. He suggested that the Eurozone would be faced with the choice of a breakup or closer political union. He was of the opinion that the latter solution would be chosen.

The book ends with a postscript entitled The EU in 2013: Debt Defaults and More?, which Janet Kersnar prepared as an article for Knowledge@Wharton. This summarizes the various views expressed at the conference.

The discussion at the conference was very lively, reflecting the variety of views on the current situation in the Eurozone and at the same time the difficulty of reconciling them. Our intention is not to take a stance on these views, but rather present all of them in this book and let the readers draw their own conclusions. Our hope is that this book will contribute to making one step further in finding the right solutions to preserve the achievements that the Eurozone has reached so far.

A recording of the conference can be viewed at the link
http://www.eui.eu/DepartmentsAndCentres/Economics/ResearchTeaching/Conferences/LifeintheEurozone/Index.aspx.

This e-book is available for free download at the following links:
http://www.eui.eu/Personal/Carletti/
http://www.eui.eu/DepartmentsAndCentres/Economics/ResearchTeaching/Conferences/LifeintheEurozone/Index.aspx
http://finance.wharton.upenn.edu/FIC/FICPress

Franklin Allen, Elena Carletti and Giancarlo Corsetti

1
The Current Situation: The Euro Crisis: A Crisis of PIGS?

Ramon Marimon

In this chapter, I will briefly comment on the current situation in the Euro area. I am going to concentrate on the - so called - PIGS countries (Portugal, Ireland, Greece and Spain), with particular focus on the Iberian ones (Portugal and Spain).

At the dawn of the millennium, PIGS countries, with the exception of Greece, seemed to be in good shape. There was great rhetoric at the European Union level, arguing that by 2010 these countries would be part of the most competitive and dynamic knowledge-based economy in the world (recall 'The Lisbon Agenda' launched in the Lisbon 2000, and reinforced in the Barcelona 2002, European Councils). Thus, PIGS countries, having passed the 'Maastricht test' and being fully-fledged members of the Euro-club, benefited from 'the Euro great moderation' of the turn of the century and, therefore, were able to obtain cheap credit in international capital markets, while also getting some additional support from the European Union, in the form of structural funds which often needed co-financing. Even if 'The Lisbon Agenda' envisioned many reforms, at that point in time people were asking, Why should we reform right now? Why we do not do what the aristocrats do, what the banker at the door says: borrow? In fact, that is what PIGS countries did. Some countries like

Greece and Portugal borrowed from the beginning of 2000. Other countries, like Ireland and Spain, did not borrow much at the beginning of the new millennium, but they did later on (see Table 1.)

Table 1. Balance on Current Account

									Projections		
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2016
Advanced Economies	**–0.7**	**–0.7**	**–1.2**	**–1.2**	**–0.9**	**–1.1**	**–0.3**	**–0.2**	**–0.3**	**–0.2**	**–0.6**
United States	–4.7	–5.3	–5.9	–6.0	–5.1	–4.7	–2.7	–3.2	–3.2	–2.8	–3.4
Euro Area[1]	0.4	1.2	0.4	0.4	0.2	–0.6	–0.2	0.1	0.0	0.0	0.1
Germany	1.9	4.7	5.1	6.5	7.6	6.7	5.0	5.3	5.1	4.6	3.6
France	0.7	0.5	–0.5	–0.6	–1.0	–1.9	–1.9	–2.1	–2.8	–2.7	–2.2
Italy	–1.3	–0.9	–1.7	–2.6	–2.4	–2.9	–2.1	–3.5	–3.4	–3.0	–2.4
Spain	–3.5	–5.3	–7.4	–9.0	–10.0	–9.7	–5.5	–4.5	–4.8	–4.5	–3.5
Netherlands	5.6	7.6	7.4	9.3	6.7	4.3	4.6	7.1	7.9	8.2	6.0
Belgium	3.4	3.2	2.0	1.9	1.6	–1.9	0.8	1.2	1.0	1.2	2.4
Austria	1.7	2.2	2.2	2.8	3.5	4.9	2.9	3.2	3.1	3.1	3.2
Greece	–6.6	–5.9	–7.4	–11.2	–14.4	–14.7	–11.0	–10.4	–8.2	–7.1	–3.8
Portugal	–6.5	–8.4	–10.4	–10.7	–10.1	–12.6	–10.9	–9.9	–8.7	–8.5	–5.7
Finland	4.8	6.2	3.4	4.2	4.3	2.9	2.3	3.1	2.8	2.6	2.8
Ireland	–0.0	–0.6	–3.5	–3.6	–5.3	–5.6	–3.0	–0.7	0.2	0.6	0.1

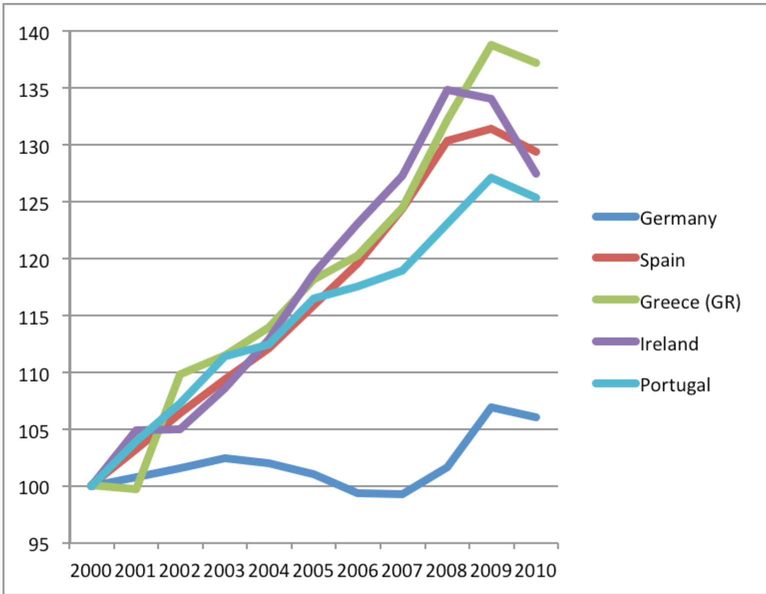
Source: IMF World Economic Outlook, April 2011.

As a consequence of this excessive borrowing in international capital markets, housing prices and investment increased dramatically in most PIGS countries.[1] They became less competitive as labour costs went up in comparison to Germany (see Fig. 1). Moreover, governments started borrowing, and government primary balances went down (see Figs. 2 and 3).

The Euro area has experienced different growth stories. In terms of economic growth rates, PIGS countries, with the exception of Portugal, were doing relatively well at the beginning of the millennium. For instance, Spain from the late 1990s to 2007 experienced growth rates well above the Euro area, but then growth collapsed as a consequence of the financial and sovereign debt crisis. A similar case, although much more pronounced, is that of Ireland (see Table 2).

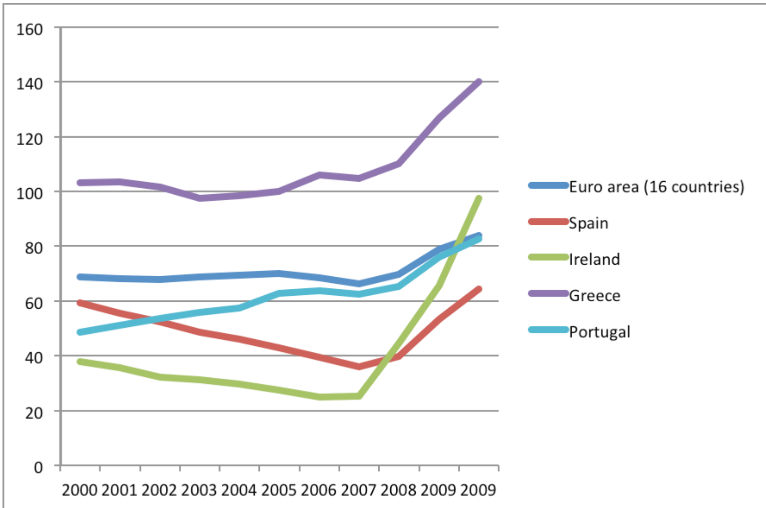
1 For example, Spanish housing prices went from a yearly growth rate of around 5% at the turn of century to a peak of 20% in 2004. While housing prices growth rates went down after this peak to turn of the century levels by the end of 2006, investment in housing reached its peak in the third quarter of 2006: 9.4% of GDP (see: Jesús Fernández-Villaverde and Lee Ohanian, "La crisis española desde una perspectiva mundial2, in La Crisis de la Economía Española: Análisis Económico de la Gran Recesión, FEDEA, Madrid, 2010).

Figure 1. Normalized Unit Labour Costs



Source: Eurostat

Figure 2. Government Debt to GDP ratio



Source: Eurostat

Figure 3. Governments Primary Balances

Source: Eurostat

Table 2. Differences in Growth Rates in the Euro Area

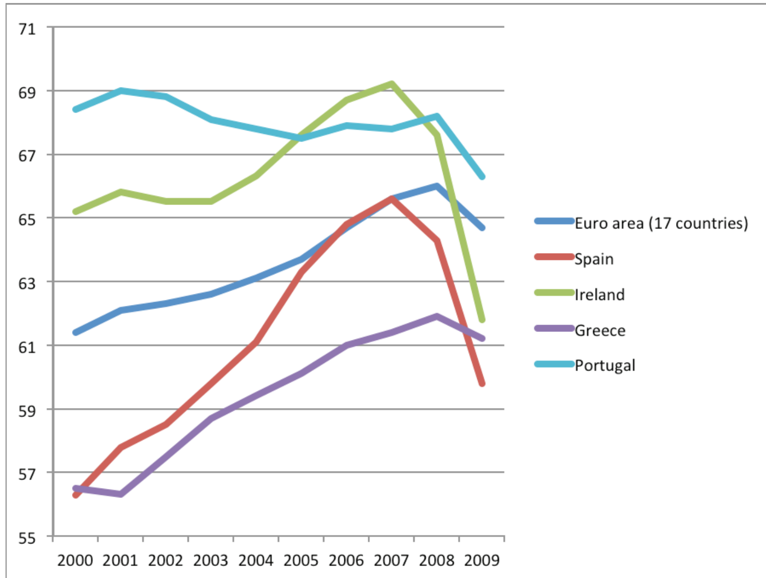
	Average									Projections		
	1993–2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2016
Real GDP												
Advanced Economies	**2.8**	**1.9**	**3.1**	**2.7**	**3.0**	**2.7**	**0.2**	**–3.4**	**3.0**	**2.4**	**2.6**	**2.4**
United States	3.4	2.5	3.6	3.1	2.7	1.9	0.0	–2.6	2.8	2.8	2.9	2.7
Euro Area[3]	2.1	0.8	2.2	1.7	3.1	2.9	0.4	–4.1	1.7	1.6	1.8	1.7
Germany	1.5	–0.2	0.7	0.9	3.6	2.8	0.7	–4.7	3.5	2.5	2.1	1.3
France	2.0	1.1	2.3	2.0	2.4	2.3	0.1	–2.5	1.5	1.6	1.8	2.1
Italy	1.6	0.0	1.5	0.7	2.0	1.5	–1.3	–5.2	1.3	1.1	1.3	1.4
Spain	3.2	3.1	3.3	3.6	4.0	3.6	0.9	–3.7	–0.1	0.8	1.6	1.7
Netherlands	2.9	0.3	2.2	2.0	3.4	3.9	1.9	–3.9	1.7	1.5	1.5	1.8
Belgium	2.3	0.8	3.1	2.0	2.7	2.8	0.8	–2.7	2.0	1.7	1.9	1.9
Austria	2.2	0.8	2.5	2.5	3.6	3.7	2.2	–3.9	2.0	2.4	2.3	1.8
Greece	2.7	5.9	4.4	2.3	5.2	4.3	1.0	–2.0	–4.5	–3.0	1.1	2.9
Portugal	2.7	–0.9	1.6	0.8	1.4	2.4	0.0	–2.5	1.4	–1.5	–0.5	1.2
Finland	3.5	2.0	4.1	2.9	4.4	5.3	0.9	–8.2	3.1	3.1	2.5	2.0
Ireland	7.7	4.4	4.6	6.0	5.3	5.6	–3.5	–7.6	–1.0	0.5	1.9	3.4

Source: IMF World Economic Outlook, April 2011.

PIGS countries have also experienced different employment stories. In 2000 employment rates were very low in Spain and Greece, while they were above the Euro average in Portugal and Ireland (see Fig. 4). Furthermore, prior to the collapse of global financial markets, employment growth rates were low in Greece and Portugal, while they were high in Ireland and Spain. As a consequence of the crisis, currently there are around 5 million unemployed workers in Spain. The jobs lost corresponded to those jobs created very fast during the years of rapid growth preceding the crisis. Ireland's experience was more traumatic since more jobs were destroyed during the crisis than had been created in the period 2000-2007. Portugal, on the other hand, always exhibited employment rates higher than the

rest of the Euro zone. In terms of salaries, Spain permanently showed higher increases in real salaries than in productivity. This trend had reversed by the beginning of 2010, showing that something has been learnt from the crisis.[2]

Figure 4. Different Employment Stories (Employment Rates)



Source: Eurostat

The Portuguese Case

In particular, I think that the situation of Portugal is somehow different to the situation of the other PIGS countries. In fact, I believe that the situation of Portugal is much more serious than people think and than what the employment figures reveal. Basically, Portugal does not have much margin without the implementation of radical reforms. The problem of Portugal has not been the bankers' fault. It has been neither a real estate bubble, nor a welfare state problem. Portugal faces a number of other problems. The main problem of Portugal is that it has shown persistent low growth and productivity. Another important problem is that bank assets do not look particu-

2 In fact, negotiated real wages experienced positive growth from 2008 to the beginning of 2010, while Spanish GDP and employment experienced negative growth rates in these years of crisis (see S. Bentolilla (02/12/2010) in: Nada es Gratis - http://www.fedeablogs.net/economia).

larly healthy, given the persistent borrowing over the whole period. Half of these assets are mortgages, a quarter of them are firm assets and the remaining quarter are government assets. A third problem is simply that the good people are leaving the country. Highly skilled Portuguese workers are going back to the colonies; they are going to work in Brazil and Angola. The final important problem in Portugal is that, certainly, there has not been the political mood for reforms.

In view of the problems of Portugal, the main question is: what can the rescue package rescue? It is not a question of civil servant austerity, nor a question of raising taxes. Consumption taxes can be a way to engineer a 'domestic devaluation' in a monetary union; that is, to reduce effective real wages without devaluing the currency. However, for Portugal it is hard to increase taxes with VAT already at 23%. Of course, there is room for other serious reforms. These reforms need to dismantle the protected economy, since Portugal still has a very protective economy in several dimensions. In addition, the country needs to invest in human capital and find a way to attract the good people back. The Portuguese Rescue Package of May 3, 2011[3] is possibly the most ambitious programme of reforms ever designed for the Portuguese economy and, in contrast with the Greek Rescue Package of May 2, 2010, gives a fair amount of discretion as to how it can be implemented. Nevertheless, as is common with other packages, the accent is still too much on the 'austerity side', and the political capacity to implement such a programme is uncertain at best. After all, until June 2011 it will not be known which Portuguese government will be responsible for its implementation, while even if the Greek government was known in May 2010, and many 'austerity measures' have been implemented, a year later it cannot be said that Greece has been rescued by the package, nor even that more 'cleansing' debt restructuring measures will not be needed.[4]

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3 "Portugal: Memorandum of Understanding on Specific Economic Policy Conditionality", 3 May 2011, between the Portuguese authorities and representatives of the European Commission, the ECB and the IMF [Comment added after the April 14, 2011 conference]

4 Harmonised long-term interest rates have changed from May 2010 to April 2011 in the following way: Greece, from 7.97% to 13.86%; Portugal, from 5.02% to 9.19%; Ireland, from 4.86% to 9.79%, and Spain, from 4.08% to 5.33% (Source: ECB).

Is Spain different?

In my view, Spain is in a better situation than Portugal. Although Spain has exhibited higher persistent volatility, this could also imply that it may be easier for Spain to come back to a path of economic growth. Regarding the banking sector, it seems that the big bankers have learnt the lesson of the Latin America experience. Finally, I believe that Spain has a potentially strong capacity to export and to offer quality services.

Despite the better situation of Spain in comparison to Portugal, it is clear that Spain also faces a number of major problems. The first is that Spain is characterized by a persistent dual economy (see Footnote 3). The second is that the country currently has a lost generation, which corresponds to the workers that have been doing temporary jobs or have been unemployed for long periods of time. The third is related to immigration. It is a pending reform addressing the real integration of the immigrant population. The fourth is associated with human capital. While there is a significant proportion of workers with low skills that need to be upgraded, highly skilled workers are hard both to attract and retain. The fifth problem is related to the budget decentralization of the country. In this aspect, the government needs to find proper co-responsibility for the regions. Finally, the entrepreneurial sector is relatively weak, making it difficult to observe sustainable productivity growth. In summary, while Spain is in a better situation than the other members of the PIGS team, it shares with them that recovery to sustained growth may well take a few years, and that how many years it will take depends on the political commitment and support to implement much needed reforms. Spain may not need a 'rescue package' but, like the other members of the club, it is facing the difficult problem of simultaneously meeting long-term and short-term objectives: to implement costly reforms that should bring benefits in the future - possibly, for all - but meanwhile taking into account that increasing the burden on some (e.g. reducing the opportunities for 'the lost generation') may have persistent negative effects.

2
Life in the Eurozone With or Without Sovereign Default?

Fabio Panetta

In my presentation, I will comment on two issues. First, I will review the role of the European Central Bank (ECB) in the financial and sovereign debt crisis. Second, I will comment on the possible alternative solutions to the sovereign debt crisis.

The role of the ECB in the financial and sovereign debt crisis

The role of the ECB during the financial and sovereign debt crisis has been characterized by a set of operations. These operations have changed significantly over time. In the first phase of the financial crisis, from August 2007 to September 2008, money markets became impaired and banks tightened their lending standards and increased their demand for liquidity and long-term funding. In response to this, the ECB increased the frequency of its long-term operations and extended their duration up to six-months. Moreover, in order to contain tensions in the money market, it changed the intra-monthly pattern of its refinancing operations, in order to accommodate banks' preference for front-loading in order to fulfill the reserve requirements.

In the second phase, from September 2008 to December 2009, the

financial turmoil evolved into a global financial crisis. Banks tightened their lending standards significantly. The real economy in Europe and worldwide entered into the worst recession in decades. At this point, the ECB reduced its policy interest rate down to 1% and implement the so-called non-standard measures (NSMs). These NSMs were monetary policy actions implemented to complement interest rate reductions. In the Euro area, these measures focused on banks, which are the main actors of the Euro Area financial system, with the aim of sustaining bank funding and the supply of credit through enhanced liquidity provision. Among the most important NSMs are the introduction of the Fixed Rate Full Allotment (FRFA) tender procedures in all ECB refinancing operations and the extension of the duration of refinancing operations up to one year. Other NSMs were the expansion of eligible collateral, the purchase of covered bonds, and the provision of additional foreign exchange liquidity. The implementation of these unusual measures emphasizes the fact that, in order to contain the effect of the crisis, the ECB took exceptional measures that have changed its operation framework radically.

The third phase of the financial crisis is the sovereign debt crisis, which started in April 2010. By the end of 2009, financial conditions improved and the ECB started the exit from non-standard measures. However, in the spring of 2010, tensions escalated in sovereign bond markets due to concerns regarding fiscal sustainability and the ECB decided to suspend the exit from the previous mentioned NSMs. The FRFA tender procedure was re-introduced in 3-month operations and the so-called Securities Markets Programme (SMP) was launched in May 2010. The SMP was based on the acquisitions of sovereign bonds issued by Euro Area countries. The interventions of the SMP were characterized by three facts. First, they were sterilized. This implies that they did not affect the monetary policy stance. Second, the interventions conducted by the SMP were temporary, like the other NSMs. Third, these interventions were limited in scope in order to avoid “undue volatility” and preserve the transmission of monetary policy.

Overall, the ECB operational framework has worked well during the

financial crisis, with the NSMs fitting well into the existing framework. However, it is important to emphasize that these measures have represented exceptional responses to exceptional circumstances. They are temporary, looking ahead for the return to the traditional liquidity management and to a normal scale of central bank intermediation. In this context, it is very important to study carefully the lessons that we have learnt from the financial crisis in order to design the "new normal" situation.

The sovereign debt crisis

The main causes of the financial and sovereign debt crisis were fiscal profligacy, weakness of the banking system, and low competitiveness and productivity. The main effects have been a sharp increase in primary deficits and public debt, an increase in sovereign spreads, high financial volatility, and low liquidity in capital markets.

In principle, there exists a set of possible solutions to the sovereign debt crisis in the Euro Area. The first option, inflation, is ruled out by the ECB mandate of price stability. Moreover, inflation would not solve the underlying problems. The second possibility is devaluation, which is impossible in a monetary union. Furthermore, an exit from the EMU would entail huge costs, especially for weak countries. Once we rule these two possibilities we are left with two possible solutions: default (or restructuring) of the sovereign debt; and fiscal consolidation and economic reform. I will focus on these two options in turn.

It is well known that there is a lively debate on the costs and benefits of sovereign default, with a number of arguments in favor and against it. On the one hand, the main arguments in favor of sovereign default are that it could make the burden of the fiscal consolidation socially "acceptable", and that it would solve the debt overhang problem, thus improving growth. On the other hand, there are at least three strong arguments against sovereign default. The first argument is that even after default a tough consolidation would be still necessary (the countries hit by the sovereign crisis have large primary deficits). The second argument is that the cost of debt would rise.

The third argument is that there are strong repercussions on growth associated with wealth effects, trade disruptions, capital outflows.

The prevailing view of the official sector is that the costs of default are likely to be well above the benefits and that default would not address the root causes of the sovereign debt crisis. However, this is just a piece of the story. In my view, the main reason why many in the official sector are against sovereign default is that it is very risky given its potential impact on financial stability through financial contagion and given the close link between sovereign risk and bank risk in the Euro area.

In view of these reasons, European authorities opted for the fourth solution, i.e. fiscal consolidation and economic reforms. This is a challenging task given the precarious economic and financial conditions of the European countries affected by the crisis. The success of this task will depend on how rigorously the reforms will be implemented and to what extent the actual implementation of the reforms will be sufficient to restore economic growth. The implementation of the reforms has not been exempt of problems. For instance, in the initial stage of the reform process Portugal seemed to lack political support and Greece appeared to show some degree of reform fatigue. It is important to emphasize that without economic growth, there is no plan that can be successful.

Another important factor that will affect success or failure in the fiscal consolidation is the Crisis Management Framework (CMF), which will be chosen in the European Union. Since May 2010 when the EFSF was established, there have been enormous progresses in the discussion of the CMF but there are many important issues that are still on the table.

3
Life in the Eurozone With or Without Sovereign Default?
—The Current Situation—

Helmut Siekmann

It is still too early to give a comprehensive and final analysis of the crisis. Keeping in mind the complexity of what has happened it is also problematic to come to simple and clear-cut judgements. But with this "caveat" a few facts appear to be clear:

1. From the beginning on and also now with the turn to a "sovereign debt crisis" the crisis is and has been at the core a crisis of financial institutions, mainly of some big banks, but by no means all banks.
2. In the second place, it has now become a crisis of sovereign states and other governmental institutions. They have amassed debt on a scale which is not sustainable.
3. But it should not be forgotten that there has to always be someone who lends the money; and to a large extent it was again banks and other financial institutions.
4. The risk of write-offs of sovereign debt has increasingly been transferred from the market players to the central banks as they bought or accepted sovereign debt as collateral. Only by these actions does the sovereign debt problem now directly affect European

institutions.

Despite all the turns and twists the crisis has taken so far and might take in the future it is and was in essence a crisis of banks which expand credit and lend too much money and do not charge a risk adjusted price (interest rate).

Although many analysts and some politicians have been referring to the crisis as a crisis of the euro or even worse of the European Union, it is in essence not a problem of the currency when a sovereign is not able or not willing to pay its debt. There is no stringent link between fiscal problems of a state and the currency used in this country as legal tender. Only if a government has the power to print the money it needs to pay back its debt might the currency be in danger. This is also why the ECB is not allowed to lend money to the EU or its Member States, Article 123 TFEU.

In addition to an almost complete failure of financial markets and of economic sciences, the crisis has also demonstrated a total failure of the supervisory system – both of its rules and of their enforcement.

Finally, an increasing lack of obedience to strict legal norms and contracts has been observed, and this is – in the medium term - the most frightening aspect and should be kept in mind before keenly designing new rules.

A. Definition of Sovereign Default

When pondering the effects of sovereign default, it should in the first place be clarified what is going to be the object of the analysis. Defining the matter of a discourse is not a pointless academic ritual, as one might suspect, but a prerequisite for a meaningful exchange of ideas. This simple fact seems to have slipped from memory in the present debate, in academia, in politics, and in the media. Instead, quite a bit of ambiguity has spread, which in turn leads to murky results.

The term "sovereign default" can have at least two distinctively different meanings:

1. the fact that a government entity is not willing or not able to fulfil its financial obligations properly
2. the initiation of a formalized legal procedure[1] designed to resolve a situation of insolvency or illiquidity.

This distinction ought to be observed meticulously.

In addition to these fairly precise meanings, the term “sovereign default” is often used to designate a situation of financial distress of a debtor which is a state, a government, or any other public sector entity with the exact boundaries undefined. This demarcation is so vague that it is meaningless for a scholarly debate. The public and the host of quasi-experts, however, seem to like it, as a high degree of inaccuracy saves a lot of thinking. For these reasons it shall not be used further on.

B. Insolvency and the Law

Default and sovereign default clearly have a legal connotation. In any case, insolvency, in the sense of the unwillingness or inability to pay one’s debt, is always a breach of the law and regularly a breach of contract. This is only too often forgotten. This breach disregards one of the basic principles for the functioning of a society: *pacta sunt servanda*. This principle is not only a demand of justice but also of efficiency, of economic efficiency.

Default has also close ties with insolvency or bankruptcy law: Bankruptcy law – and this is also too often forgotten - at its core provides for a procedure to distribute the assets of a failing entity in an orderly manner to the creditors. In case the entity is a legal person, it is dissolved at the end of the procedure. The bona fide natural person will eventually be relieved from all or parts of his debts. Usually a

1 This procedural aspect is mainly discussed in the context of the insolvency of a sovereign s. International Monetary Fund, Orderly and Effective Insovency Procedures – Key Issues, 1999; Aden, Insolvenzpanverfahren und Fiskalvermögen eines Staates, ZRP 2010, p. 191; Mayer, Wie nähert man sich einem internationalen Insolvenzverfahren für Staaten?, ZInsO 2005, p. 454; Mayer, Staateninsolvenz nach dem Argentinien-Beschluss des Bundesverfassungsgerichts – Eine Chance für den Finanzplatz Deutschland?, WM 2008, p. 10; Paulus, Überlegungen zu einem Insolvenzverfahren für Staaten, WM 2002, p. 725; Paulus, Rechtlich geordnetes

legal obligation – backed by criminal sanctions – has been imposed to timely petition for such a procedure in case of a legal person for two grounds:
— illiquidity
— insolvency
This is the basic setup which has developed over the centuries.

The statutory rules on insolvency, however, have been expanded in order to provide instruments to keep the failing legal entity alive if it is worth the effort: Chapter 11 of the U.S. bankruptcy code and similar provisions in the German insolvency code (sixth part "Insolvenzplan": §§ 217-285, seventh part "Eigenverwaltung": §§ 270-285). These instruments have some merits but they come at a cost, especially be-cause of their effects on competition and crisis prevention. Often they make the non-fulfilment of obligations worthwhile.

C. Insolvency of a Government Entity

Government entities of any kind, which are probably meant by the term "sovereign", have to discharge public duties. They cannot simply be dissolved at the end of an insolvency procedure. The tasks continue to exist. This makes it impossible to use the existing insolvency codes unaltered to handle the financial failing of a state.

Another distinctive difference between sovereign and private debtors is the genera-tion of revenue: States and many other government entities do not depend on mar-kets and voluntary exchange of goods to obtain the necessary resources for their existence and operation. They are entitled with taxing power. Taxing power basically implies the right to take away means from its owner without compensation.

Taxing power is one of the key features of the modern state. The legal capacity to generate income without having to deliver any goods or services in exchange is one of the crucial traits, which discerns states - or "sovereign" entities, whatever they are - from all private entities. It is, however, an open question whether such an entity commands the physical power to exercise its right against a rebellious people. An-other obstacle might be the lack of adequate resources in the

population.

When a government entity does not fulfil its financial obligations ("sovereign default"), it is a breach of legal obligations as much as it would be in the private sector. But there is an additional trait. Such a demeanor by a government entity has also to be judged by Article 126 para. 1 TFEU, which prescribes that the Member States of the EU "shall avoid excessive government deficits". This holds not only true for the members whose currency is the Euro but for *all* Member States. Although the wording leaves some room for interpretation, a deficit which leads to a default is always "excessive". Hence a default of an EU Member State is a breach of the primary law of the Union unless it can be demonstrated that *exceptional circumstances* justified the deficits.

D. The Often Forgotten Role of the Creditors

In the course of the present crisis the focus of attention has not been directed suffi-ciently on the creditors. Bailing out Greece was originally essentially bailing out French, Spanish and German banks and – what is often forgotten - their creditors. They were again salvaged without sufficient (legal) reason for shifting the burden of a default from (private) creditors to the taxpayer. In Germany it was again to a large extent the usual suspects which are anyhow owned or were taken over by German government entities: HRE, Commerzbank, and several Landesbanken. Similar findings are true for the shielding of Ireland and Portugal.

The desirable close scrutiny of the *reasons* why those banks *lend a breath–taking amount of money to sovereign entities*, whose credit is not beyond any doubt, is still overdue. This should be in the focus of attention. Mandatory clauses to allow a restructuring of bonds - now in the legislative process - might mitigate the problem to some extent but leave a lot of questions open, for example in respect of risk weight of "sovereign debt" in statutory rules. Serious flaws and inconsistencies exist in the regulatory framework, especially on capital adequacy, which have not been ad-dressed so far.

However, in the meantime a tacit bail-out of banks (bank holding com-

panies) and private creditors has taken place. Especially in Germany a major fraction of southern European sovereign debt is now not only held by state owned banks[2] but by agencies of the federal government[3] founded to help restructuring some of the failing German banks.[4] They are no banks but are often referred to as "bad banks".[5] A large share of the debt is also held by the European System of Central banks.

E. Prevention of Default

The EU-law on economic and fiscal policy is so far primarily oriented towards prevention and not so much on crisis resolution. This is also one of the reasons why ad-hoc measures had to be taken in the case of Greece and why the temporary support mechanisms the EFSM and EFSF were set up "somewhat" outside the framework of the Treaty – with quite some legal risk.

I. Fiscal discipline

1. Primary law of the EU

In the words of the primary law "sustainability" of fiscal policy is required. The Maas-tricht Treaty declared "the sustainability of the government financial position" to be the essential criterion for the necessary convergence which in turn forms the basis for the monetary union.[6] Even if this clause belongs to the transitional provisions it can be used as a basis for interpretation of the permanent requirement that "Member States shall avoid excessive government debts".[7] The compliance with *budgetary discipline* is a permanent obligation

2 KfW appr. 8,4 billion Euro Greek sovereign debt, Commerzbank appr. 2.9 billion Euro Greek sov-ereign debt, state banks appr. 2,5 billion Euro Gree, sovereign debt.

3 Appr. 8.8 billion Euro Greek sovereign debt.

4 Westdeutsche Landesbank AG, Hypo Real Estate Holding AG.

5 WestLB AG has transferred 85 billion Euro to the "Erste Abwicklungsanstalt", founded 11 Dezember 2009. It is a public law entity within the "Finanzmarktstabilisierungsanstalt" which in turn is a public law entity guaranteed by the Federal Republic of Germany. 1 Oktober 2010 HRE has transferred loans and securities to the amount of about 173 billion Euro to the "FMS Wertmanage-ment", another public law entity within the "Finanzmarktstabilisierungsanstalt". A large portion of these portefolios is southern European government debt.

6 Article 140 (1) indent 2 TFEU.

7 Article 126 (1) TFEU.

of all Member States.[8] It has to be monitored by the Commission on the basis of two reference values: the ratio of the planned or actual government deficit to gross domestic product and the ratio of government debt to gross domestic product.[9] The reference values are specified in the protocol (No. 12) on the excessive deficit procedure added to the Maastricht Treaty and are carried through in the Treaty on the Functioning of the European Union (Lisbon Treaty).[10] They read as follows:

— 3% for the ratio of the planned or actual government deficit to gross domestic product at market prices;

— 60% for the ratio of government debt to gross domestic product at market prices.[11]

The protocol with the reference values is part of the primary law of the Union.[12] They are quite frequently referred to as "Maastricht Criteria". This might cause confusion as the admission criteria mentioned above are also called "Maastricht Criteria". For this reason it should always be made clear which criteria are meant and the latter be called "convergence criteria".

In essence, both the procedural and the substantial rules for enforcing the require-ment of permanent budgetary discipline are laid down in the primary law of the Union.[13] However, true sanctions have not been embodied. Specifically an exclusion of a Member State from the Eurozone is not foreseen.[14] But already at the initiation of the monetary union serious concerns were raised that the procedure provided in the primary law would be too tedious and – above all – the political determination would be lacking to impose sanctions.[15] Definitions and specifications of the

8 Hahn, Der Stabilitätspakt für die Europäische Währungsunion, JZ 1997, p. 1133.

9 Article 126 (2) TFEU.

10 Protocol (No 12) on the excessive deficit procedure, Official Journal C83, 30/3/2010, p. 279.

11 Article 1 of the protocol.

12 Article 51 TEU.

13 Article 126 (2) – (14) subparagraph 1 TFEU.

14 P. Kirchhof, Die Mitwirkung Deutschlands an der Wirtschafts- und Währungsunion, in: Festschrift Franz Klein, 1994, p. 61 (72).

15 Zeitler, Die Europäische Währungsunion als Stabilitätsgemeinschaft, Wertpapier-Mitteilungen, 1995, 1609 (1611).

rules on gov-ernment debt and deficits and the deficit procedure have been undertaken by the secondary law of the Union but no reduction of the scope of discretion for imposing sanctions.[16]

2. Secondary law of the EU

For this reason predominantly Germany demanded a "stability pact" preferably with *automatic* sanctions.[17] This was, however, not compatible with the discretionary powers of the Commission and the Council in the primary law.[18] A separate treaty – complementing the provisions in the TEC on the monetary union - would have been questionable from the legal point of view as well.[19] Changing clauses of the primary law of the Union would not be possible; supplementing them only in fields which do no yet fall into its competences or which have been left explicitly open to further accords.[20] As a result the somewhat awkward type of pact that we have at present was finally realized.

a) The original stability and growth pact of 1997

To enhance the compliance with the requirement of permanent budgetary discipline the so called stability and growth pact has been set up by secondary law of the Union. The term "pact" was coined to emphasize the underlying political consensus even though the term is used in other legal acts of the European Union in the strict sense of the word. It can be considered to be a reminiscence of the initially discussed separate treaty. This has been the cause for some confusion in the not so well informed public. Technically the pact consists of

16 Council Regulation (EC) No 3605/93 of 22 November 1993 on the application of the Protocol on the excessive deficit procedure annexed t the Treaty establishing the European Community, Official Journal L 332, 31.12.93, p. 7; amended several times, codified version: Council Regulation (EC) No 479/93 of 25 May 2009, on the application of the Protocol on the excessive deficit procedure annexed t the Treaty establishing the European Community, Official Journal L 145, 10.6.2009, p. 1; Council Regulation (EC) no 3603/93 of 13 December 1993 specifying definitions for the application of the prohibitions referred to in Articles 104 and 104b (1) of the Treaty, Official Journal L 332, 31.12.93, p. 1.

17 Details by Hahn, Der Stabilitätspakt für die Europäische Währungsunion, JZ 1997, p. 1133 (1134).

18 Now Article 126 AEUV.

19 Smits, The European Central Bank, p. 85; Häde, Ein Stabilitätspakt für Europa?, EuZW 1996, 138 (140).

20 Häde, Ein Stabilitätspakt für Europa?, EuZW 1996, 138 (142).

one resolution of the European Council,[21] which is not binding, and two – binding – regulations of the Council. One contains mainly substantive provisions[22] and the other mainly procedural rules.[23] The resolution contains a multilateral promise to achieve an almost balanced budget in the medium range.

The regulations are part of the secondary law of the Union. Regulation 1466/97 was based on Article 99 (5) TEC and contains an early warning system and the obligation of the Member States to provide a stability program. Regulation 1467/97 was based on Article 104 (14) TEC and attempts to speed up the procedure and to clarify it.

b) The amendments of 2005

Mainly on behalf of France and – ironically – Germany, these regulations were amended in 2005[24] when France and Germany failed to comply with the reference values. The amendments left the reference criteria untouched, since they are also part of the primary law of the Union,[25] but allowed to take more circumstances into account to excuse from a failure to meet them. Discretionary powers were extended. Procedural provisions were also changed to make it more difficult to adopt sanctions against non-compliant Member States. In addition to that, the deadlines for imposing sanctions were prolonged. These amendments were preceded by a Council decision not to continue with the deficit-procedure against France and Germany which was later declared not to be in accordance with the European

21 Resolution of the European Council on the Stability und Growth Pact Amsterdam, 17 June 1997, Official Journal C 236, 2.8.1997, p. 1.
22 Council Regulation (EC) no 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, Official Journal L 209, 2.8.1997, p. 1; amended by Council Regulation (EC) no 1055/2005 of 27 June 2005, Official Journal L 174, 7.7.2005, p. 1.
23 Council Regulation (EC) no 1467/97 of 7 July 1997 on speeding up and clarifying the implementa-tion of the excessive deficit procedure, Official Journal L 209, 2.8.1997, p. 6; amended by the Council Regulation (EC) no 1056/2005 of 27 June 2005, Official Journal L 174, 7.7.2005, p. 5.
24 Council Regulation (EC) no. 1055/2005 of 27 June 2005, Official Journal L 174, 7.7.2005, p. 1; Council Regulation (EC) no. 1056/2005 of 27 June 2005, Official Journal L 174, 7.7.2005, p. 5.
25 Art. 51 TEU. It might be argued, however, that they could be modified by acts of the secondary law on the basis of Article 126 (14) subparagraph 2 TFEU.

Union law by the Court of Justice.[26]

c) The proposed reform of the pact

Again under pressure from Germany the Commission submitted on 29 September 2010 a comprehensive package of measures to prevent and correct macroeconomic imbalances including procedures to prevent and handle excessive budget deficits. A major part of the package is proposals for amending the stability and growth pact. The main subject matters of the package are:

1. An alert mechanism through a scoreboard[27]
2. Preventive surveillance based on discussions with the Member States and in-depth reviews[28]
3. A budgetary framework for Member States
4. Amendments of the excessive imbalance procedure (EIP) applying to EU Member States
5. An enforcement mechanism for the Euro area members.

Altogether six legislative proposals for concrete legal instruments were submitted. The regulation on the prevention and correction of macroeconomic imbalances is completely new. It is set up to detect imbalances and to establish a corrective procedure.[29] Also new is the regulation that aims to establish national budgetary frame-works of quality.[30] These requirements for the budgetary frameworks of all Member States are based on Article 126 (14) TFEU. In particular, they aim to specify the obligations of national authorities to comply with the provisions of Article 2 of the Protocol (No 12) on the exces-

26 ECJ, Judgement of 13/7/2004 – C-27/04 (Commission vs. Council), Europäische Zeitschrift für Wirtschaftsrecht, 2004, p. 465; Juristen-Zeitung, 2004, p. 1069 with comment Kotzur; see also Dutzler/Hable, Das Urteil des Europäischen Gerichtshofs zum Stabilitäts- und Wachstumspakts – eine Klarstellung?, Vierteljahreszeitschrift des Instituts für Europäische Politik 27 (2004), p. 301.

27 Articles 3 and 4 proposal for a Regulation of the European Parliament and of the Council on the prevention and correction of macroeconomic imbalances, COM(2010) 527 final, 2010/0281 (COD).

28 Article 5 proposal for a Regulation of the European Parliament and of the Council on the prevention and correction of macroeconomic imbalances, COM(2010) 527 final, 2010/0281 (COD).

29 Proposal for a Regulation of the European Parliament and of the Council on the prevention and correction of macroeconomic imbalances, COM(2010) 527 final, 2010/0281 (COD).

30 Proposal for a Council Directive on requirements for budgetary frameworks of the Member States, COM(2010) 523 final, 2010/0277 (NLE).

sive deficit procedure.

Two proposals are submitted for amending the regulations which constitute in essence the stability and growth pact.[31] They are based on Articles 121 and 126 TFEU.

The new enforcement mechanism for the euro area members is directed to budgetary surveillance[32] and to correct excessive macroeconomic imbalances.[33]

The effective enforcement of budgetary surveillance is based on Article 136 in combination with Article 121 (6) TFEU. The respective regulations are now called the "preventive" arm and the "corrective" arm of the stability and growth pact. They allow fines not only for excessive deficits but also for exceeding the debt level of the reference values. The discretionary power of the Council is reduced significantly.[34]

The package clearly contains elements of a common fiscal policy for the Member States and a first step towards macroeconomic guidance. It reminds one of the "planification" in France and the "global steering" of the economy ("Globalsteuerung"), which had been attempted in Germany from 1966 on but largely failed.

3. Lack of common fiscal policy

A common fiscal policy is in theory not indispensable for the func-

31 Proposal for a Council Regulation (EU) amending Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, COM(2010) 526 final, 2010/0280 (COD); proposal for a Council Regulation (EU) amending Regulation (EC) No 1466/97 on speeding up and clarifying the implementation of the excessive deficit procedure, COM(2010) 522 final, 2010/0276 (COD).
32 Proposal for a Regulation of the European Parliament and of the Council on the effective enforce-ment of budgetary surveillance in the euro area, COM(2010) 524 final, 2010/0278 (COD).
33 Proposal for a Regulation of the European Parliament and of the Council on enforcement meas-ures to correct excessive macroeconomic imbalances in the euro area, COM(2010) 525 final, 2010/0279 (COD).
34 Proposals 522 and 526 final, p. 3.

tioning of a monetary union. The adverse effects of an unsustainable fiscal policy could be left to the markets. Markets tend, however, to react (too) late and – as we have seen – in a not very rational manner.[35] The rationality of financial markets has proven to be largely a myth. That is why it was prudent by the Maastricht Treaty to establish rules about a sustainable fiscal policy of the participating states to prevent a situation where sanc-tions of the market (high interest rates, denial of loans) would have to come in and remind a member of the Eurozone of its (legal) obligations.[36]

The widespread complaint about the lack of a common fiscal policy (or even a com-mon economic policy) reveals an almost total ignorance of the present design of federal systems. The constitution of the United States of America does not provide for a common fiscal policy of the members of the federation. In contrast to Germany the U.S. constitution allows to a large extent grants of the federal government to the states; also under conditions. With those strings attached, the federal government can exert some influence on the policy but this is far from a federal equalization system or even a common taxation. So far there is no clear evidence that the great autonomy of the states in the U.S. has adversely affected the functioning of the currency used there. Of course, in the long run too diverse developments might threaten the stability of the whole setup but that is not primarily a problem of the monetary system. It is a question of coherence of the federation in general.

In essence, the EU appears to have more rules to secure a sound fiscal policy of its members than the U.S. has for its states on the constitutional level; and there is no fundamental criticism that the U.S. dollar cannot work in a federation with so little common economic and fiscal policy. Especially rules on (balanced) budgets are definitely state law and a request for financial aid by the state of California was

35 This was known already at the time of framing the monetary union: Report on economic and mone-tary union in the European Community, OPOCE, 1989, p. 24; later Beson, L'euro et les marchés fi-nanciers, in: L'euro dix ans après, Colloque de la CEDECE, 18 juin 2010.

36 The states were to be exposed to the reactions of the markets on their fiscal policy Häde, Haushaltsdisziplin und Solidarität im Zeichen der Finanzkrise, EuZW 2009, 399 (402).

turned down by the federal government.

Also the constitution of the Federal Republic of Germany contained no clause re-stricting debt or deficit of the members of that federation. In the German constitution only a weak clause had been introduced in 1969 that both the central state ("Bund") and its members ("Länder") should align their fiscal policy to the requirements of the macro-economic balance and that for this reason restrictions on borrowing could be imposed by the federation. In addition to that, it could be decreed that reserves were to be built up during economic upswings that could be spent during downturns to stimulate the economy. These rules were strictly reserved to fight business cycles and not to cope with structural deficits in the budgets; and they were anyhow disregarded.

It took as long as 2009 until the federal constitution of Germany was amended and for the first time binding rules on deficits for the states ("Länder") were introduced by the central state ("Schuldenbremse"). Until then the European Union had - also compared with the central government of Germany - more legal rules directing the fiscal policy of its Member States than the Federal Republic of Germany. This led to the awkward result – and it was one of the reasons for the fundamental changes of the fiscal federalism in Germany in 2009 – that the federal government could not legally force the Länder to avoid "excessive deficits" in order to fulfill Germany's obligations towards the European Union!

The amendments to the German constitution imposing stiffer rules on the member states of the federation abolishing basically the right of the "Länder" to run a structural deficit from fiscal year 2020 on, raise quite some constitutional concerns because it had been an undisputed right of the members of any kind of federation to finance part of their budget by borrowing money. Interdicting any structural deficit except in time of disaster might have taken away too much "sovereignty" from the "Länder". They might have lost an essential part of their "statehood" or "sovereignty". This would be a breach of the federal constitution since the amending power is limited in

Germany, Article 79 (3) of the federal constitution.[37] A case on this question is pending in the Federal Constitutional Court of Germany.

II. Rules for Financial Aid

1. Necessity of support

European Union law does not contain an (explicit) legal obligation to support Member States with financial problems. When creating the Monetary Union there was a clear decision against establishing an equalization system which could provide for such assistance.

Only Article 122 para. 2 TFEU was – as a compromise – finally designed in a way that it can serve as a basis for financial aid but only under extraordinary circums-tances. But it does by *no means* establish a *claim*, not even an *obligation* to assist. Even if the very restrictive preconditions are met it is totally up to the discretion of the Council to grant the aid: "Where a Member State is in difficulties or is seriously threatened with severe difficulties caused by natural disasters or exceptional occur-rences beyond its control" such aid may be provided.[38]

This clause demonstrates further that from the point of view of the EU-law a default of a Member State is considered to be in the first place an internal problem of the affected state and its respective creditors. It is not desirable and instruments have been set up to prevent it, but when it occurs crisis fighting and resolving mechanisms have been set up only for those Member States, whose currency is not the Euro ("Member States with a derogation"[39]).[40] From this point of view, default is also not considered to be a problem of the common currency, the EURO, even if some media and many politicians relentlessly claim the opposite. The framers of the Maastricht Treaty did this knowingly and willingly as otherwise the boundary to a true

37 New rules imposing rigid limits on the "Länder" to run a budget deficit are considered to be incom-patible with Article 79 (3) of the federal constitution, see e.g. Hancke, Defizitbegrenzung im Bundesstaat – Verfassungsmäßigkeit einer verbind-lichen Verschuldungsregel für die Bunde-sländer, DVBl. 2009, 621 (626).
38 Article 122 para. 2 TFEU.
39 Article 139 para. 1.
40 Article 143.

federal system would have been touched or even transgressed with severe consequences in regard of German constitutional law. This is also the reason why clear limits for support of government entities by the Union or the ECB have been set up.

2. Potential support measures

a) No privileged access of public sector to financing

Any privileged access to financial institutions by Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law or public enterprises is strictly prohibited by EU primary law.[41] Thus the banking system has to be dismissed as an instrument to prevent a sovereign default.

b) No assumption of sovereign debt by the Union or its members

To strengthen the determination of the Member States to comply with the required budgetary discipline the Treaty explicitly excludes any liability of the Union or any Member State for the commitments[42] of any central government or any other public sector entity of a Member State. Not only liability is legally excluded but also the (voluntary) assumption of such commitments. The wording leaves some space for interpretation as bilateral payments or credit guarantees must not necessarily be judged as "assuming" a commitment.

c) No financing of the public sector by the ECB

Any type of credit financing of the Union or the Member States by the ECB or by a central bank of a Member State is strictly prohibited. This prohibition is absolutely comprehensive. It holds not only for the Union and central governments but for all other bodies, offices or agencies, regional, local or other public authorities. It includes all other bodies governed by public law and public enterprises.[43] An exception is only made for those publicly owned credit institutions which can be given the same access as commercial banks.[44]

To secure this strict interdiction the ECB and the national central

41 Article 124 TFEU.
42 Article 125 para. 1 TFEU.
43 Article 123 para. 1 TFEU.
44 Article 123 para. 2 TFEU.

banks may not purchase any debt instruments issued from the public sector. This covers especially government bonds. However, only the "direct" purchase is forbidden. This way the Eurosystem should be enabled to intervene in the markets to procure their proper functioning. In no way was it intended to open a back door for an (indirect) financing of governments. Keeping this in mind, the purchase of government bonds the ESCB started in early summer 2010 was from the beginning onwards not without a legal risk. The longer it lasts the more it becomes legally questionable as proper functioning of the markets can hardly be used any more as a justification. So it is *not* a question of the structure of the balance sheet of the ECB when it demands that the support of some of the Member States with debt problems have to be supported with other tools and its purchases have to terminate now.

d) Voluntary support

There might be, however, an opening for voluntary financial aid by the Union or its Member States. The wording of Article 125 TFEU does not prohibit it explicitly but it is often contended that it would change the nature of the EU and would jeopardize the basis of the monetary union. Often the term "Transferunion" is used in this context. So the reluctance of Germany to participate in support mechanisms is not pri-marily based on short sighted opportunistic reasons, as often is contended, but on very serious legal grounds. A deviation from the outlined principles would almost automatically lead to a constitutional question in Germany as it would overstretch the mandate given by the German legislature for the transfer of sovereign powers to the EU.[45]

The Treaty intended to disallow any support payments for a Member State in dis-tress. This was made especially clear as in a separate clause (voluntary) financial assistance is allowed under certain, very restrictive conditions: "Where a Member State is in difficulties or is seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences beyond its control" such aid may be provided.[46] The wording leaves, however, some space for interpreta-

45 Fassbender, Der europäische „Stabilisierungsmechanismus" im Lichte von Unionsrecht und deutschem Verfassungsrecht, NVwZ 2010, p. 799 (801-803).
46 Article 122 para. 2 TFEU.

tion as bilateral payments or credit guarantees must not necessarily be judged as "assuming" a commitment. Also the term "occurrences beyond its control" might be interpreted in different ways. It was inserted later in the course of the framing process of the Treaty as a result of compromise.[47] This way any incentive for circumventing the rules should be excluded.

These rules do, however, not apply to Member States of the European Union whose currency is not the Euro. In case a "Member States with a derogation"[48] is in "difficulties or seriously threatened with difficulties as regards its balance of payments the Council can eventually grant "mutual assistance" and "appropriate methods" therefore.[49] In case a "sudden crisis" in the balance of payments occurs the Member State may take the necessary protective actions as well.[50]

Such measures have been taken in the case of Hungary, Latvia and Romania. They are a common instrument of the EU administered by the Commission. In this case the EU is considered to be allowed to borrow money on the financial markets. In the course of the present crisis the Council has expanded the sum granted twice: from €12 to €25 to €50 billion.

The mere existence of the rules governing the ways and means to support Member States in financial distress shows that the Treaty did not want to allow it in other instances.

In one of the most recent scholarly publications in Germany dealing with the problem it has, however, been pointed out that following Article 3 para. 1 TFEU a distinction has to be made between exclusive competences of the EU and competences it shares with the

47 See for details Louis, The no-bailout clause and rescue packages, Common Market Law Review, vol. 47 (2010), p. 971 (982), who favors an interpretation which would allow voluntary aid under strict conditionality; similarily Hermann, Griechische Tragödie – der währungsverfassungsrecht liche Rahmen für die Rettung, den Austritt oder den Ausschluss von überschuldeten Staaten aus der Eurozone, EuZW 2010, 413 (415).
48 Terminology introduced by the Treaty of Lisbon, Article 139 para. 1 TFEU.
49 Article 143 para. 1 subpara. 2, para. 2 TFEU.
50 Article 144 para. 1 TFEU.

Member States.[51] Monetary policy for the Member States whose currency is the euro falls under the exclusive competences of the EU and this leaves no space, absolutely no space, for national measures. This could be set in contrast to economic policy which is not mentioned there and only partially in Article 6 TFEU. These shared competences would leave space for measures of the Member States.

Budgetary rules and fiscal policy in general could be treated in a similar way. As far as provisions exist, they have to be obeyed, e.g. Article 126. Actions of the EU need a mandate. The principle of subsidiarity and the principle of conferral hold, Article 5 TEU. This restricts substantially potential actions of the EU. But Member States - not the EU - would be free to grant financial aid or to set up a permanent support mechanism as far as they follow the spotty provisions set up in this field by the Treaty. This could also be done in conformity with the constitutional law of Germany.

The proposed amendment to the Treaty (Article 136 para. 3 new TFEU)[52] follows apparently this line of thinking.

III. Support for Greece

In May 2010 financial support was given to Greece because of the imminent danger that the country could not refinance its outstanding debt and because its budget deficit which after some corrections of the statistics reached a two-digit number as a fraction of the GDP. The aid was basically granted as credit guarantees on a bilateral basis. Greece had promised to solve its budgetary problems by a rigorous austerity program with spending cuts, tax rises and an overall reduction in social security benefits.[53]

Whether the aid is in conformity with the principal provisions of the Treaty is questionable. The wording "assume the commitments" in Article 125 para. 1 TFEU would have to be interpreted in a way that

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51 Thym, Euro-Rettungsschirm: zwischenstaatliche Rechtskonstruktion und verfassungsgerichtliche Kontrolle, EuZW 2011, p. 167.
52 Infra IV.
53 See for details Louis, The no-bailout clause and rescue packages, Common Market Law Review, vol. 47 (2010), p. 971.

new voluntary guarantees by Member States would not be covered. Article 122 para. 2 TFEU could be a basis when the situation of the Greek finances would be considered to be an "exceptional occurrence beyond the control" of Greece.

IV. Temporary Support Mechanisms

A few days after the rescue operations for Greece the heads of states and government of the Member States agreed to set up a support mechanism on a much larger scale for future financing problems of Member States. It was going to have an accumulated volume of euro 750 billion, distributed on three pillars:

— European Financial Stability Mechanism (EFSM) (€60 billion)
— European Financial Stability Facility (EFSF) (€440 billiion)
— Credits by the International Monetary Fund (IMF) (€250 billion).

The lion's share of the aid should be granted in the form of guarantees and not in direct payments. The good credit ratings of most Member States were to be used to refinance the outstanding debt at much lower costs than the failing countries could have negotiated. The whole support mechanism was designed to be only of temporary nature to terminate by 2013. It should (possibly) be replaced by a permanent solution on a sound legal basis.

1. Credits of the International Monetary Fund (IMF)

The support mechanism is completed by loans from the International Monetary Fund (IMF). For some time there was strong resistance against the participation of the Fund in rescue operations within the EU or more precisely in the Euro area as it is designed to give support in the case imbalances due to the lack of foreign currencies. The fund, however, commands a lot of experience in doing so and it is neutral towards many special interests within the Union. In addition, there are few alternatives as long as the EU has not set up a fund of its own and still wants to provide aid.

2. European Financial Stability Mechanism (EFSM)

The European Financial Stability Mechanism is an instrument of the European Union. It is financed from general funds of the Union and administered by the Commission. Setting up an instrument of the EU is questionable from a legal point of view unless a very broad interpretation of Article 122 para. 2 TFEU can be supported.

3. European Financial Stability Facility (EFSF)

The European Financial Stability Facility is a separate entity set up by the Member States that have introduced the euro. It is designed as a special purpose vehicle to borrow money on the capital markets by issuing debt instruments guaranteed by the Member States not in need. The proceeds are passed on to the member in distress. This way there is no direct aid from Member States or the Union to other members. The volume of guarantees was distributed according to the share each member central bank's holdings of the capital of the ECB. The liability is limited to that fraction.

Technically a corporation under the law of Luxembourg with a seat in Luxembourg City was set up. This corporation issues bonds which are guaranteed by the various Member States. The corporation was given the desired top rating by the rating agen-cies. Its first application was the support for the Republic of Ireland.

4. Purchase of debt instruments by the ECB

In addition to this three-pronged mechanism the purchase of debt instruments issued by Member States by the ESCB since early summer 2010 played a considerable and growing role with the result that a major share of the sovereign debt of the supported members or its banks is already held by the ECB. Only a fraction of it is actually bought and held by the ECB. The rest is carefully distributed among the national central banks. A "restructuring" of sovereign debt would hit now to a great extent the ESCB.

As the legality of this procedure has become increasingly doubtful with time passing on, the ECB has rightfully demanded that this task has to be fulfilled by the rescue mechanism set up by the EU. According to the fundamentals of the monetary union resolving bud-

getary problems of Member States is in no way a task of the ECB or the ESCB as a whole.

The recent augmentation of the capital of the ECB has not been necessary in view of the purchase of the "sovereign" debt instruments even if the ECB takes into account a certain risk that they may fail. A central bank does not have to follow any kind of capital adequacy rules since it cannot become insolvent. It can even carry on a loss on its balance sheets indefinitely. It is unclear whether the taxpayer eventually will have to bear a loss, as it is everything else but sure that the Member State whose central bank shows finally a loss in consequence of capital requirements of the ECB will be liable for those losses. The same holds true for direct losses of the national central banks.

So it is not only economic reasons but primarily obedience to the law that the purchase of these debt instruments has to come to an end.

V. Creation of a Permanent Support Mechanism (ESM)

The heads of states and governments agreed 17 December 2010 to lay ground for a permanent support mechanism.[54] It was recognized that it would be legally prudent to structure it as a (multilateral) support of the members of the Eurozone and not of the EU.[55] As consequence a new paragraph 3 of Article 136 TFEU was created following the procedure set up by Article 48 TFEU to serve as a sound legal basis for this mechanism. This provision allows Member States, not the EU, to grant support on a voluntary basis under strict conditionality.[56] The details of the new European Stabili-zation Mechanism (ESM) are still being negotiated.

F. Conclusion

(1) In the primary law of the EU several safeguards have been set up to prevent the default of a Member State.

54 Draft European Council Document EUCO 30/10 of 17.12.2010.
55 Thym, Euro-Rettungsschirm: zwischenstaatliche Rechtskonstruktion und verfassungsgerichtliche Kontrolle, EuZW 2011, 167.
56 Attachment to Bundesrat-document 872/10.

(2) This includes budgetary rules which exceed the provisions for the members of federal systems like the U.S. or Germany (until 2009).

(3) The Maastricht Treaty refrained deliberately from setting up any kind of equaliza-tion system.

(4) A claim for financial assistance within the Eurosystem does not exist and its conformity with German constitutional law would be questionable.

(5) A default of a Member State would be the result of an illegal budgetary policy of the respective state but it would not infringe the law of the EU when the Union or its Members let it happen.

(6) Voluntary financial aid of the EU to a Member State is allowed only under very narrow conditions. Whether they are fulfilled in the present crisis is questionable.

(7) A support mechanism set up by the Member States aside from institutions of the Union could be judged as in conformity with EU law and German constitutional law.

Appendix

I. The IMF

Dubious competence according to the IMF Agreement

Article V - Operations and Transactions of the Fund

Section 1. Agencies dealing with the Fund

(…)

Section 2. Limitation on the Fund's operations and transactions

(…)

Section 3. Conditions governing use of the Fund's general resources

(a) The Fund shall adopt policies on the use of its general resources, including policies on stand-by or similar arrangements, and may adopt special policies for special balance of payments problems, that will assist members to solve their balance of payments problems in a manner consistent with the provisions of this Agreement and that will establish adequate safeguards for the temporary use of the general resources of the Fund.

(b) A member shall be entitled to purchase the currencies of other members from the Fund in exchange for an equivalent amount of its own currency subject to the following conditions:

(i) the member's use of the general resources of the Fund would be in accordance with the provisions of this Agreement and the policies adopted under them;

(ii) the member represents that it has a need to make the purchase be-cause of its balance of payments or its reserve position or developments in its reserves;

(iii) the proposed purchase would be a reserve tranche purchase, or would not cause the Fund's holdings of the purchasing member's currency to ex-ceed two hundred percent of its quota;

(iv) the Fund has not previously declared under Section 5 of this Article, Article VI, Section 1, or Article XXVI, Section 2(a) that the member desiring to purchase is ineligible to use the general resources of the Fund.

II. The EU and its members

1. No excess deficits

Article 126 TFEU

1. Member States shall avoid excessive government deficits.

2.-14. (…)

2. No privileged access to financial institutions

Article 124 TFEU

Any measure, not based on prudential considerations, establishing privileged access by Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States to financial institutions, shall be prohibited.

3. No assumption of sovereign debt by Union or Member States

Article 125 TFEU

1. The Union shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project. A Member State shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of another Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project.

2. The Council, on a proposal from the Commission and after consulting the European Parliament, may, as required, specify definitions for the applica-tion of the prohibitions referred to in Articles 123 and 124 and in this Article.

4. Only Support by the EU under exceptional circumstances

Article 122 TFEU

1. Without prejudice to any other procedures provided for in the Treaties, the Council, on a proposal from the Commission, may decide, in a spirit of solidarity between Member States, upon the measures appropriate to the eco-nomic situation, in particular if severe difficulties arise in the supply of certain products, notably in the area of energy.

2. Where a Member State is in difficulties or is seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences be-yond its control, the Council, on a proposal from the Commission, may grant, under certain conditions, Union financial assistance to the Member State concerned. The President of the Council shall inform the European Parliament of the decision taken.

III. The ECB

1. Financing of sovereign entities by the ECB prohibited

Article 123 TFEU (101 TEC)

1. Overdraft facilities or any other type of credit facility with the European Central Bank or with the central banks of the Member States (hereinafter re-ferred to as 'national central banks') in favour of Union institutions, bodies, of-fices or agencies, central governments, regional, local or other public authori-ties, other bodies governed by public law, or public undertakings of Member States shall be prohibited, as shall the purchase directly from them by the European Central Bank or national central banks of debt instruments.

2. Paragraph 1 shall not apply to publicly owned credit institutions which, in the context of the supply of reserves by central banks, shall be given the same treatment by national central banks and the European Central Bank as private credit institutions.

2. Indirect purchase legal but restricted by powers of ECB:

Article 127 TFEU (105 TEC)

1. The primary objective of the European System of Central Banks (hereinafter referred to as the ESCB) shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic poli-cies in the Union with a view to contributing to the achievement of the objectives of the Union as laid down in Article 3 of the Treaty on European Union. (…)"

2. The basic tasks to be carried out through the ESCB shall be:

— to define and implement the monetary policy of the Union,
— to conduct foreign—exchange operations consistent with the provisions of Article 219,
— to hold and manage the official foreign reserves of the Member States,
— to promote the smooth operation of payment systems.

3.- 6. (…)

IV. Proposed Amendment to Article 136 TFEU

The Member States whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality.

4
Ireland's Sovereign Debt Crisis

Karl Whelan

1. Introduction

Among the countries currently experiencing sovereign debt crises, Ireland's case is perhaps the most dramatic. As recently as 2007, Ireland was seen by many as top of the European class in its economic achievements. Ireland had combined a long period of high economic growth and low unemployment with budget surpluses. The country appeared to be well placed to cope with any economic slowdown as it had a gross debt-GDP ratio in 2007 of 25% and a sovereign wealth fund worth about €5000 a head.

Fast forward four years and Ireland is shut out of sovereign debt markets and in an EU-IMF adjustment programme. Its debt-GDP ratio has soared over 100% and the sovereign wealth fund is effectively gone. In this short paper, I provide a brief review of how this rapid change came about and discuss potential future developments in relation to Ireland's sovereign debt situation.

2. The Rise and Fall of the Celtic Tiger

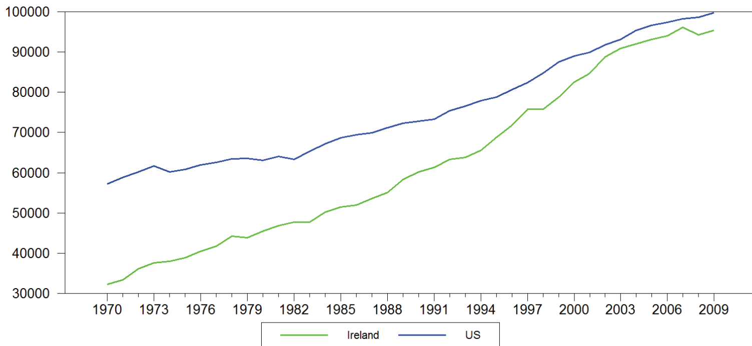
It is now well known that Ireland's famed "Celtic Tiger" ended with the collapse of a housing bubble and a banking crisis. Many have

thus been tempted to describe the Irish boom as largely built on an unstable credit splurge. However, this would underestimate the true progress made by the Irish economy during the two decades prior to 2007.

The Birth of the Tiger

Before the "Celtic Tiger" became a well-known phrase during the 1990s, the Irish government had implemented a wide range of policies that helped to produce large increases in labour productivity. The 1960s saw a move away from protectionist trade policies and set Ireland on the path to EU membership in 1973. Industrial policies focused successfully on encouraging export-oriented foreign direct investment. There was also a gradual improvement in educational standards as policies to provide universal secondary education in the 1960s were subsequently followed by a large expansion of the third-level sector. As a result of these policies, Irish productivity growth consistently outpaced other advanced economies from the early 1970s onwards and by the middle of the last decade, Irish labour productivity was very close to US levels (see Figure 1)[1].

Figure 1: US and Irish Labour Productivity (PPP-Adjusted, Source: US BLS)



While Ireland's pre-Tiger supply-side policies may have been good ones, its macroeconomic stabilisation policies were not so good. Ireland reacted to the global slowdown of the 1970s by running very large fiscal deficits, which cumulated in a debt crisis in the 1980s. At the same time, the traditional currency link with sterling was dropped

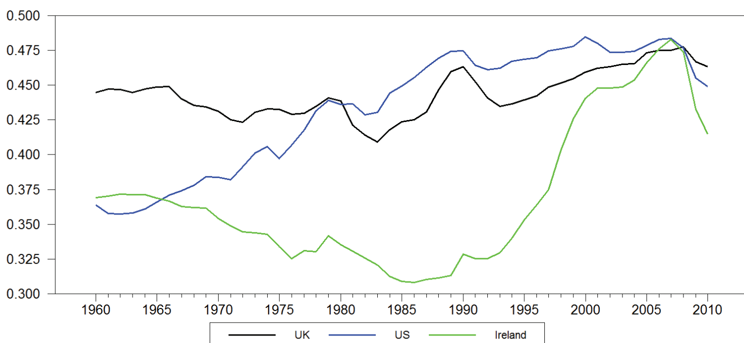
1These data come from the US Bureau of Labor Statistics International Comparisons website. www.bls.gov/fls/intl_gdp_capita_gdp_hour.htm.

for membership of the European Monetary System, which provided an unstable monetary regime featuring regular devaluations.
By the mid-1980s, Ireland had a debt-GDP ratio over 110 percent and was paying out almost 10 percent of GDP per year in interest payments. Tax rates had been raised to punitive levels in a series of failed attempts to stabilise the deficit and growth had stagnated.

It was at the depths of this previous crisis that the birth of the Celtic Tiger took place. The period from 1987 onwards saw fiscal problems dealt with via a programme that focused on restraining spending and by 1989, Ireland's debt dynamics had clearly moved in direction of sustainability. At the same time, the EMS finally also delivered a period of monetary stability. With macroeconomic stability restored and good fundamental policies in place, the Irish economy began to grow at an impressive rate.

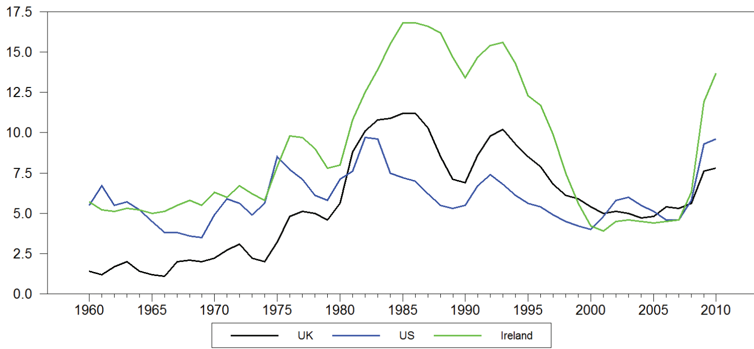
Indeed, Ireland in the late 1980s was primed for growth. While its workers were becoming increasingly productive, Ireland was significantly under-employed by international standards. As Figure 2 shows, only about 30 percent of the population was at work in the late 1980s. This underemployment partly reflected an exceptionally high unemployment rate (Figure 3). However, it also reflected demographic and social factors.[2]

Figure 2: Employment-Population Ratios of Ireland, UK and US



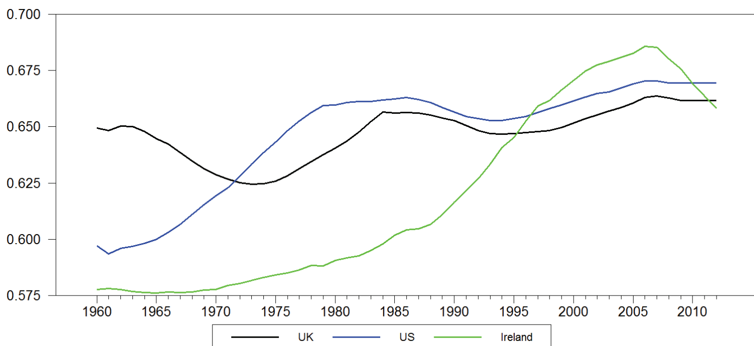
2 See Honohan, Patrick and Brendan Walsh (2002). "Catching up with the Leaders: The Irish Hare," Brookings Papers on Economic Activity part 1, pages 1-57. and Whelan, Karl (2010). "Policy Lessons from Ireland's Latest Depression," The Economic and Social Review, Volume 41, pages 225-254.

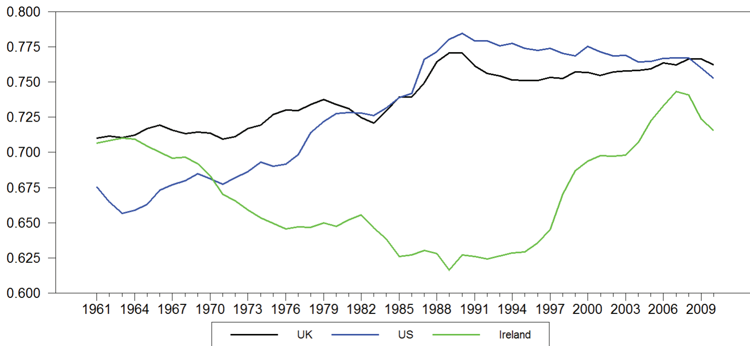
Figure 3: Unemployment Rates



Ireland's baby boom occurred in the 1970s and peaked in 1980, so the depressed Ireland of the 1980s was supporting a very large population below working age. This demographic pattern gradually unwound over time so that by the late 1990s, Ireland had a higher fraction of the working age population than either the US or the UK (see Figure 4). Ireland in the late 1980s also had a very low rate of labour force participation: While female labour force participation had increased steadily in other countries throughout the 1960s and 1970s, this pattern was not replicated in Ireland (see Figure 5). However, when the economy recovered, there was a large female labour supply ready to enter the workforce.

Figure 4: Fraction of the Population Aged between 15 and 65.





The combination of these factors meant that the Irish economy became an incredible employment creating machine. Employment rose steadily from 1.1 million in the late 1980s to 2.1 million in 2007. Combined with steady improvements in productivity, the Irish economy delivered a period of extraordinary growth: From 1987 to 2007, economic growth averaged 6.3 percent per year.

This exceptional economic growth allowed Irish governments to achieve a holy grail that was the envy of politicians around the world: They lowered tax rates and raised spending year in and year out and yet economic growth delivered sufficient tax revenues to generate a string of budget surpluses. By 2007, Ireland's low stock of debt appeared to position the country well for coping with a slowdown.

The Housing Boom

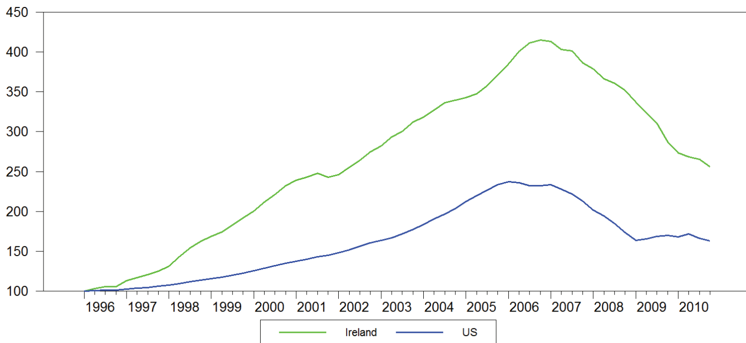
Unfortunately, Ireland's position in 2007 was not nearly as strong as it appeared to many outsiders or to the government of the time. Despite high levels of labour productivity, the later years of the Irish boom saw the build-up of dangerous imbalances. At the heart of these imbalances was an extraordinary housing boom.

At the turn of the millennium, Ireland still had a relatively small housing stock, the smallest stock per capita in the European Union.[3] With population growing, incomes expanding rapidly and EMU

3 Somerville, R.A. (2007). "Housing Tenure in Ireland," The Economic and Social Review, pages Volume 37, 107-134.

providing access to mortgage finance at historically low rates, there was a surge in the demand and ability to pay for housing. As a result, house prices in Ireland quadrupled between 1996 and 2007, a pace of increase double that seen in the United States over the same period (see Figure 6).

Figure 6: House Prices in Ireland and the US



The response to this increase in housing demand was an extraordinary construction boom. The total stock of dwellings—which had stood at 1.2 million homes in 1991 and had gradually increased to 1.4 million homes in 2000—exploded to 1.9 million homes in 2008. House completions went from 19,000 in 1990 to 50,000 in 2000 to a whopping 93,000 in 2006. Figure 7 puts this in context by comparing house completions per capita with their equivalent in the United States. It shows that while Ireland's rate of housing completions during the 1970s and 1980s, had been comparable to that seen in the US, housing activity gradually increased in Ireland—particularly after 2002—to the point where per capita completions were four times as high in Ireland as in the US.

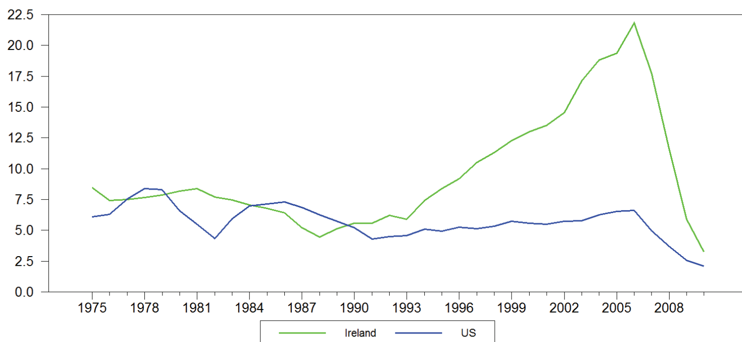
Construction became a dominant factor in the Irish economy. With the economy already at full employment, much of the labour employed in the construction boom came from the new EU member states in Eastern Europe, and this inward migration further fuelled the demand for housing. By 2007, construction accounted for 13.3 percent of all employment, the highest share in the OECD. Indeed, with the exception of Spain and Portugal, Ireland's share of construc-

tion employment exceeded all other OECD member states by almost five percentage points.

The Irish government of recent years placed much of the blame for the economic collapse on the international financial crisis. However, the evidence suggests that Ireland was heading for a rough landing even in the absence of an international recession. Measured against various "fundamental" factors, Irish house prices became more and more over-valued and, by early 2007—well before the first outbreaks of the international crisis—Irish house prices began to fall.[4]

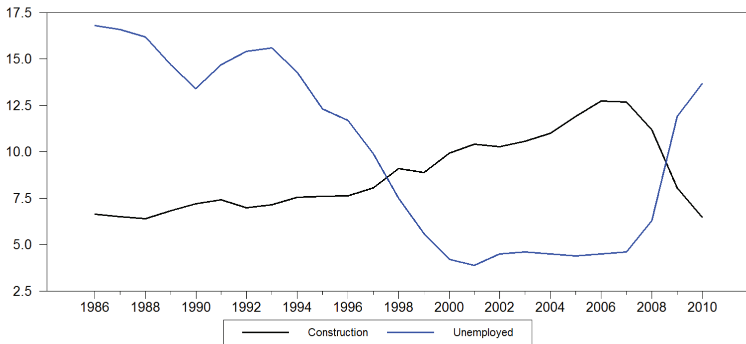
As house prices fell, the demand for new houses began to collapse with the attitude of potential buyers swiftly changing from being desperate to "get on the property ladder" to deciding to wait to get a better price later. In mid-2008, the new Minister for Finance, Brian Lenihan noted that the housing market had "come to a shuddering halt". Figure 7 illustrates the scale of the collapse in housing construction, while Figure 8 shows how the subsequent decline in construction employment directly accounted for about two-thirds of the jump in the Irish unemployment rate after 2007. House prices have now fallen about 40 percent from their peak values and continue to fall.

Figure 7: Housing Completions Per Thousand People



4 There was relatively little discussion in Ireland at the time of the idea that house prices were unsustainable even though it didn't require sophisticated analysis to suggest that house prices were over-valued. Notably, when Irish academic economists such as Alan Ahearne or Morgan Kelly questioned the sustainability of house prices, they received a very negative reaction from the Irish government.

Figure 8: Fraction of Labour Force in Construction and in Unemployment



3. The Sovereign Debt Crisis

With the Irish economy having placed so many of its eggs in the construction basket, one might have expected the authorities to have been careful to prepare for what was going to be an inevitable slowdown. This, however, was not the case. While a very low debt-GDP ratio due to years of fast economic growth may have appeared to provide a significant cushion against any downturn, Ireland's fiscal situation turned out to be heavily dependent on the health of its property sector.

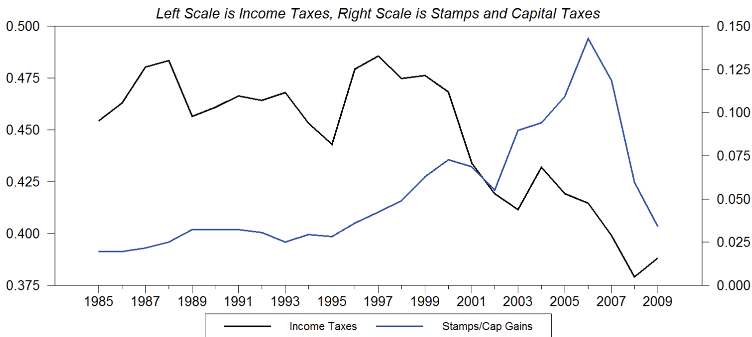
A Huge Deficit Opens Up

The collapse in construction activity, and the corresponding jump in unemployment, resulted in a large loss in income tax revenues and an increase in social welfare payments but if the fiscal consequences of the housing crash had been limited to these impacts, Ireland would have been positioned to cope well. However, Ireland's tax base had been altered during the later periods of the boom to collect more and more tax revenue from construction activity.

Figure 9 shows the share of total tax revenue due to income taxes (the black line on the left scale) and due to asset-based taxes such as

stamp duties, capital gains tax and capital acquisition tax.[5] Thanks to booming housing activity and surging house prices, the share of tax revenue due to these asset-based taxes rose steadily during the 1990s and then rapidly during the period after 2002. At the same time, there was a corresponding reduction of a similar magnitude in the amount of revenue collected from income taxation. When construction activity collapsed, this substantial source of government revenue disappeared almost overnight.

Figure 9: Composition of Tax Revenues



By late 2008, the collapse in construction activity was apparent and the world economy was entering a severe recession. Irish real GDP declined by 3.5 percent in 2008 and by 7.6 percent in 2009. Despite having had years of budget surpluses, Ireland was suddenly facing a yawning fiscal gap. Indeed, it was apparent by early 2009 that, without fiscal adjustments, Ireland was heading for deficits of as large as 20 percent of GDP.

The scale of these potential deficits meant that, despite the low starting level of debt, the Irish government realised there was no room for discretionary fiscal stimulus to ease the effects of the severe downturn. Instead, from late 2008 onwards, the Irish government has implemented a sequence of contractionary budgets featuring a cumulative total of tax increases and spending cuts worth €20.8 bil-

5 Ireland does not have a standard property tax. Instead, the government levied a stamp duty tax that was paid in full when a house was purchased. With high levels of housing activity, this collected a lot of revenue during the boom and almost nothing in recent years.

lion. These adjustments are the equivalent of 13 percent of 2010's level of GDP or €4,600 per person and represent the largest budgetary adjustments seen anywhere in the advanced economic world in modern times.[6] Despite these enormous adjustments, the decline in the size of the Irish economy has been so severe—nominal GDP has declined by almost 20 percent—that the European Commission are still projecting a budget deficit of 10.6% in 2011.

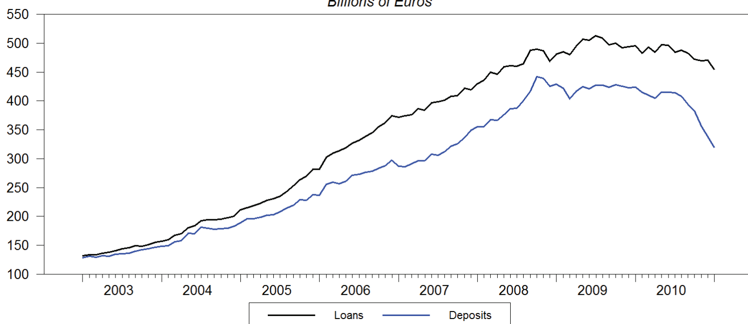
The Banking Crisis

The tale of the Irish fiscal crisis is gruesome enough if one focuses alone on the collapse of the construction sector and its effects on revenues and expenditures. However, the straw that broke the Irish camel's back was the effect on the state finances of the government's attempts to deal with a banking crisis.

The acceleration in housing activity after 2002 that is evident in Figure 10 was largely financed by the Irish banks. These banks significantly changed their business model during the later years of the boom. Prior to 2003, the Irish banks had operated in a traditional manner, with loans being roughly equal to deposits. After 2003, these banks increased their property lending at rapid rates and financed much of this expansion with bonds issued to international investors.

Figure 10: Loans and Deposits at the Guaranteed Irish Banks

Billions of Euros



6 The IMF's October 2010 World Economic Outlook examined historical episodes of fiscal consolidation in fifteen advanced economies over 1980-2009. As a percentage of GDP, Ireland's 2009 consolidation was the biggest the IMF researchers could find. The subsequent adjustments for 2010 and 2011 were of similar size. International Monetary Fund (2010). World Economic Outlook, Chapter 3: "Will it Hurt? Macroeconomic Effects of Fiscal Consolidation".

From less than €15 billion in 2003, international bond borrowings of the six main Irish banks rose to almost €100 billion (well over half of GDP) by 2007. In addition to rapidly expanding their mortgage lending, the Irish banks also built up huge exposures to property developers, many of whom had made fortunes during the boom and were "doubling down" on property with ever more extravagant investments. Many of these development loans were used for investments that could only have paid off if property prices continued to rise. Leading the way was the now-notorious Anglo Irish Bank, which specialised in property development. Anglo expanded its loan book at over 20 percent per year and is now known to have had a series of serious corporate governance problems.

During 2008, as evidence built up of the scale of the Irish construction collapse, international investors became concerned about the exposure to property investment loans of the Irish banks. These banks found it increasingly difficult to raise funds on bond markets and by late September 2008, two weeks after the collapse of Lehman Brothers, the Irish bankers turned up at government buildings looking for help.

The Irish government's decision on September 30, 2008 to give a near-blanket guarantee for a period of two years to the Irish banks has been, and will continue to be, hotly debated. The government appears to have taken seriously the assurances of the Irish Central Bank that the banks were fundamentally sound and were merely suffering from a short-term liquidity problem. Thus, the government appears to have believed that the guarantee would not have consequences for the state finances. However, there is also evidence that senior civil servants, as well as Merrill Lynch (who had been recruited as advisors in the weeks prior to the decision) warned against the dangers of a blanket guarantee.

By Spring of 2009, it became apparent that the losses at the Irish banks were extremely large, most notably at the dreaded Anglo Irish Bank. This paper will not focus on the various strategies the Irish government adopted from that point onwards to deal with the crisis. However, the fact that the liabilities of the banks were guaranteed by

the government played a key role in limiting options to restructure insolvent banks in a way that would have seen losses shared with private creditors. Thus, in 2009, the government began using state funds to recapitalise the guaranteed banks.

The Endgame

By 2010, it was clear to international financial markets that in addition to a serious problem with its budget deficit, Ireland was facing a large bill of uncertain size in relation to fixing its banking sector. A National Asset Management Agency (NAMA) was set up to issue government bonds to the banks to purchase distressed property assets at a discount and as 2010 went on and NAMA acquired more properties, it became clear that the final bill for recapitalising the Irish banks would be enormous.

In September 2010, the government provided a "final estimate" that Anglo Irish Bank would cost the state about €30 billion or almost €7000 per person living in Ireland today. The cost of these losses is being covered by a "promissory note" which will make cash payments over a number of years but which was fully counted against Ireland's general government deficit in 2010, leading to what must be a world record official deficit of 32 percent of GDP.

As the economy failed to show evidence of a strong recovery, international markets also became increasingly concerned with the future losses of the Irish banks due to mortgages and business loans. The banks had been able to issue bonds from late 2008 to early 2010 under the protection of the state guarantee. However, as concern about potential sovereign default began to rise, this guarantee ceased to be of much use. Many of the bonds that had been issued matured in September 2010, when the original guarantee ran out.

When the banks failed to find new sources of market funding to roll maturing bonds or replace the corporate deposits that also began to leave the system at this point, they turned to the ECB for emergency funding. Borrowing from the ECB by the guaranteed banks, which had been negligible prior to the crisis, jumped from €36 billion in April 2010 to €50 billion in August to €74 billion in September.

The banks also began to run out of eligible collateral to use to obtain loans from the ECB, at which point the ECB allowed the Central Bank of Ireland to begin making "emergency liquidity assistance" loans to the Irish banks.

International markets, which had been reasonably confident throughout 2009 that Ireland would make it through without a sovereign default and which generally had a favourable view of the Irish government's fiscal adjustment programme, became increasingly concerned that the Irish banking sector was going to destroy the creditworthiness of the Irish sovereign. Bond yields on sovereign debt rose in September and October and then moved up dramatically in November following the famous Deauville declaration of Mrs. Merkel and Mr. Sarkozy.

4. The EU-IMF Bailout and Future Prospects

By mid-November, the game was up for the Irish government. Failing to see any sign of improvements in the banking situation, the ECB appears to have made its continued support for the Irish banking system contingent on Ireland applying the EU and IMF for a multi-year lending programme.

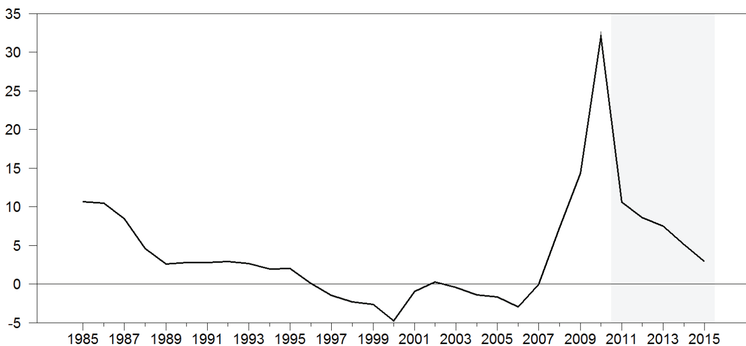
The EU-IMF Deal

In late November, the Irish government agreed a multi-year funding deal with the EU and the IMF. The programme contained commitments to implement a further €15 billion in fiscal adjustments over the period 2011-2014, including a €6 billion adjustment for 2011 that was implemented in the budget passed in December 2010. Figure 11 shows the path for the Irish budget deficit that is projected by the European Commission. The deficit is projected to remain high over the next few years but to gradually move towards 3 percent of GDP in 2015.

The EU-IMF programme also contains a set of measures to stabilise the banking sector. Rather than stabilise the banking situation, the announcement of the EU-IMF deal appears to have intensified the

problem for a while, as deposits continued to flee the Irish banking system and reliance on central bank funding increased even further. The programme included a commitment to conduct a further round of "stress tests" on the Irish banking system. These tests were released at the end of March and were accompanied by a commitment from the Irish government to provide a further €24 billion in funding to recapitalise the continuing Irish banks to high levels.[7] It remains to be seen whether these announcements will stabilise the funding situation for these banks.

Figure 11: Budget Deficit as a Percent of GDP



With the latest announcements, the Irish government has now provided (or is about to provide) recapitalisation funds of about €70 billion (about 45 percent of the 2010 level of GDP) to offset the losses made by the Irish banks. Some of this money may eventually provide a return if the state's shares in banks such as Allied Irish or Bank of Ireland are sold to private ownership at some point in the future but the vast majority of these funds are simply gone.

Debt Sustainability

The official EU-IMF line is that Ireland will return to borrowing in the sovereign debt markets in late 2012 and will be able to do so at rates that allow the debt to be sustained. This will be re-enforced by a slow but steady return to economic growth that will see the economy growing by 3 percent per year in real terms by 2014.

7 Anglo and the smaller but equally profligate Irish Nationwide Building Society are being wound down.

The black line in Figure 12 shows the debt-GDP ratio that would be associated with this relatively rosy scenario. The debt-GDP ratio, which had been as low as 25 percent in 2007 but is estimated to be 112 percent in 2011 is now projected to peak at 120 percent in 2013 and only slowly decline thereafter. Interest as a share of GDP, which had started the crisis at only one percent, is projected to stabilise at about 6 percent in GDP, while the primary deficit is projected to move from 8.6 percent in 2010 to a primary surplus of 3 percent in 2015 (see Figure 13).

Figure 12: Debt-GDP and Debt-GNP

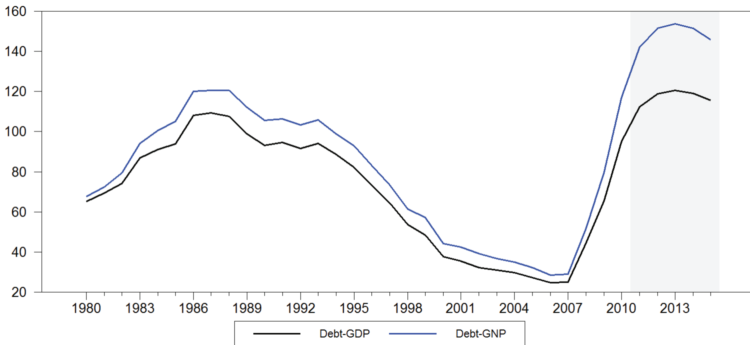
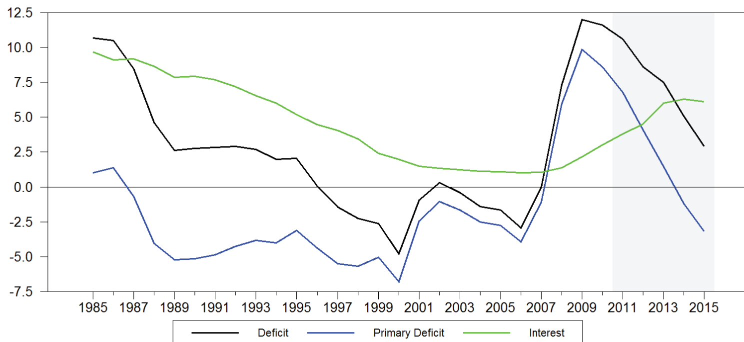


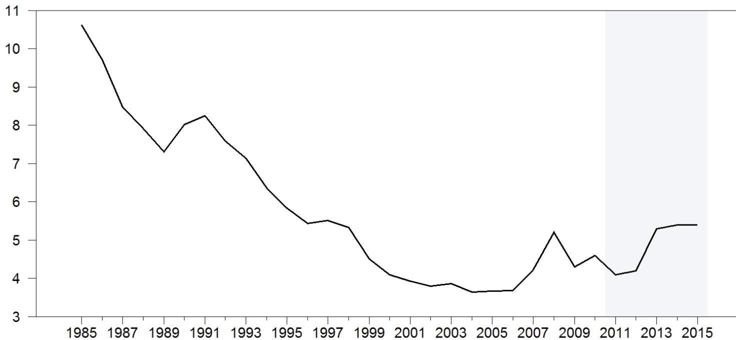
Figure 13: Composition of Non-Bank Deficit (EC Projections)



There are some arguments in favour of such a scenario occurring. Despite very high yields on secondary market debt, the coupon rates on Ireland's existing private debt are very low. The average interest rate that Ireland paid on its debt in 2010 was about four and half percent. The average interest rate on EU-IMF package of 45 percent of GDP is higher than that on existing debt but it also has a relatively

long maturity of seven and half years, so Ireland will not be under huge pressure over the next few years to replace this funding with private borrowing. Thus, official projections are based on the idea that the average interest rate that the Irish government will pay on its debt will stabilise at about 5.4 percent in 2014 (see Figure 14) which provides room for a small primary surplus to start reducing the debt ratio.

Figure 14: Average Interest Rate on Irish Government Debt



There are also some compelling arguments against the official scenario. The assumed return to steady 3 percent growth may be too optimistic. Ireland cannot rely on a return of many of its previous sources of growth such as productivity catch up, demographic patterns and growth in participation.

Fiscal adjustment and debt overhang problems will continue to depress domestic demand. And while the Irish government regularly points to the role improving competitiveness should play in boosting exports in the coming years, the plan appears premised on a smooth recession-free ride for the world economy in the coming decade. It also assumes that the government will not be providing further funds to recapitalise the Irish banking sector, which owes vast quantities to emergency lending to the ECB and Irish Central Bank. Taken together, the official analysis paints a fairly rosy scenario which may not come to pass.

Another factor worth noting is that Ireland's debt burden looks even

higher when measured relative to GNP as opposed to GDP. For most countries, there is very little distinction between these two measures. However, a large (indeed, increasingly large) fraction of Irish output is due to profits that are repatriated by multinationals. The relatively low corporate tax rate of 12.5 percent that is charged on these profits has been a repeated source of controversy but it is unlikely that the Irish government is going to introduce large changes to this rate as it is seen as central to industrial policy. For this reason, most of the tax burden falls on the domestic incomes measured by GNP and as the blue line in Figure 12 illustrates, this measure of the debt-burden is set to top 150%.

As of now, financial markets appear to be placing more emphasis on the negative factors than on the positive factors stressed by the EU and the IMF. Yields on Irish government debt are above 10 percent and this pricing appears to be based upon the assumption that there will be a debt restructuring. Against this background, the official plan's assumption that private sovereign borrowing will recommence in late 2012 seems optimistic. There may be some secondary market activity in Irish debt at the current high yields but it's questionable whether Ireland can sell the large amounts of debt that would be required to finance itself once the EU and IMF funds run out.

An ESM Solvency Test?

Based on the European Commission's projections, Ireland is likely to run out of money in early to mid-2013 if it cannot access funds in the private sovereign bond market. At present, my guess is that Ireland will not be able to sufficiently return to the sovereign bond market to avoid having to request funds from the new European Stability Mechanism.

According to the ESM "term sheet" released in March, a request for funds from the ESM will require a "sustainability analysis" to assess whether "a macro-economic adjustment programme can realistically restore the public debt to a sustainable path."[8] If the debt burden is deemed unsustainable, then "the beneficiary Member State will be required to engage in active negotiations in good faith with its

8 See www.gouvernement.lu/salle_presse/actualite/2011/03-mars/21-mes/esm.pdf

creditors to secure their direct involvement in restoring debt sustainability."

It is not clear how such a sustainability analysis will work but if the Irish government manages to stick to its current adjustment programme and the macroeconomic assumptions underlying this programme come to pass, it seems likely that an ESM analysis will produce similar projections to those currently published by the EU and IMF showing a stabilisation and reduction in the debt-GDP ratio. Most likely, under such a scenario, the debt will be deemed sustainable. If, however, Ireland falls short of the targets set in the current adjustment programme and the debt outlook looks worse in 2013, then this will raise the question of whether private sector debt should be restructured.

A Uruguay style "light dusting" restructuring (to borrow the phrase used by Buchheit and Gulati, 2011)[9] in which maturities are extended while coupon payments are maintained at existing levels, may prove attractive for the EU and IMF because a second deal for Ireland would see the balance of risk on Irish sovereign debt shifting over from private bondholders to the official sector. Moreover, with both the IMF and soon the ESM claiming a creditor status that is senior over private bondholders, such a deal could be a tipping point that rules out private purchases of Irish government bonds for a number of years. A light dusting approach would lock in a large volume of privately supplied funds that could share the burden that could be associated with any later more severe restructuring of Irish sovereign debt.

Which route is chosen, and how any potential restructuring is organised, are likely to depend on events elsewhere. Greece appears to be closer to the point of sovereign debt default than Ireland and the consequences of any attempts to restructure Greek debt would have a significant impact on the attitude of the European authorities to applying a similar approach to Ireland.

9 Buchheit, Lee and G. Mitu Gulai (2011). "Greek Debt – The Engame Scenarios", *Life in the Eurozone With or Without Sovereign Default?* Eds. Franklin Allen, Elena Carletti and Giancarlo Corsetti. USA, FIC Press 2011, pp.83-95. e-book

5
Quo vadis, Euroland? European Monetary Union Between Crisis and Reform

Martin Hellwig

1. European Monetary Union Before 2008

Developments of the past year have led many to say: We told you so. European Monetary Union was bound to erode the stability culture that the Bundesbank had nourished so that other countries were bound to follow. The temptation to finance budget deficits through the printing press would be overwhelming. And this prediction has now been confirmed. All the safeguards of the Maastricht Treaty and the Stability and Growth Pact have come to naught.

This reaction comes in particular from German economists, many of whom accompanied the formation of European Monetary Union with dire predictions. They forget that the Maastricht Treaty and the protection that European Monetary Union provided to the Bundesbank prevented Mr. Lafontaine, the new Federal Minister of Finance in 1998, from changing the Bundesbank Act so as to make the institution subservient to the Federal Government. They also forget that Mr. Schröder as Federal Chancellor was most prominent in preventing the application of the Stability and Growth Pact in the early 2000's. In other words, erosion of the stability culture of the Bundes-

bank is also a matter of generation change within Germany. There are reasons to believe that European Monetary Union has slowed this erosion rather than accelerated it.

I have previously commented on these developments in a contribution to the Festschrift for the Centenary of the Swiss National Bank, which was written in 2006 and published in 2007.[1] At the time, I stressed the following points:

- Through the formation of the European Monetary Union, monetary policy has been depoliticized. Whereas the Bundesbank was very much a part of German political debate, the ECB as a supranational institution is removed from national political debate. Moreover, national politicians who rail against the ECB's policies find that there are usually other politicians, from other countries who have different views about these policies – and who insist that the ECB is as much, or as little, beholden to them as to the railing plaintiff.
- Depoliticization does not imply an end to frictions and disputes. Disputes about the appropriate intermediate targets of monetary policy or about the tradeoff between a reliance on rules and discretion arise naturally, and the central banking community is the more likely to cultivate these conflicts, the less it feels threatened by politicians and governments. In the case of European Monetary Union there are ample grounds for such "professional" disputes because the pursuit of price stability in an area with multiple non-integrated market systems presents a difficult new challenge. Moreover, it might take time, for the institution and the surrounding media, to get used to the much decreased importance of the exchange rate.
- Threats to the ECB's independence might be expected to come from the European Commission. The European Commission has a history of ambition to enlarge its own turf. This ambition has mostly worked against Member State prerogatives, but there was every reason to expect it to work against the ECB as well. In fact, in the discussion about

1 "Switzerland and Euroland: European Monetary Union, Monetary Stability and Financial Stability", in: The Swiss National Bank 1907 – 2007, Zürich 2007.

the Constitution for the European Union, the President of the ECB had already found it necessary to protest against a suggestion, which he understood to have come from the Commission, that would have "simplified" the procedure changing some of the strategically important articles of the Statute of the European System of Central Banks and the European Central Bank.

- Lack of credibility of the "Stability and Growth Pact" was identified as a problem. It therefore seemed likely that, at some point over the medium run, we would come across a problem like the one that Greece has posed over the last year. For this eventuality, in 2006/7, I predicted that the European Union would move forward as it had in past crises, with a mixture of muddling through and changes in governance. I warned that, in such a context, the ECB's independence might be at stake. If a Treaty revision introducing a mechanism to deal with the fiscal crisis of a Member State government were to stipulate that, in such a crisis, the ECB should contribute to reducing damage and frictions and if this stipulation was part of a larger package, then the requirement that changes to the Treaty must be ratified by parliaments in all Member States would not be worth much as a safeguard for the ECB's independence.
- Finally, I argued that there is an unnatural tension in a system with a supranational authority for monetary policy and national authority in banking supervision. While appreciating that bail-outs of insolvent banks belonged in the domain of national finance ministers, I suggested that mechanisms of co-ordination and assignments of tasks for the national authorities and the central bank as a lender of the last resort were not sufficiently well specified. The information that transpired about the various memoranda of understanding on the matter did not inspire much confidence.

2. Why Is the Current Crisis so Difficult to Handle?

With hindsight, it is clear that my analysis in 2006/7 was too sanguine. Whereas I expected the coming fiscal crisis of a Member State

to be dealt with pragmatically, without too much ado, the Greek sovereign debt crisis has now been with us for over a year and the European Union is still far from finding a way out and from establishing workable governance mechanisms for the future. Moreover, we are not just dealing with the Greek sovereign debt crisis, but with crises in other countries as well.

The main reason why it has been so difficult to come to terms with these problems is that we are not just dealing with one crisis, but with three crises at the same time. We have, first, the kind of fiscal crisis that we see in countries like Greece and Portugal. We have, next, the kind of banking crisis that we see in countries like Ireland or Spain, where local banks have gone on lending sprees and nourished real-estate bubbles and, when the bubbles burst, their solvency was impaired. We have, finally, the kind of latent banking crisis that we see in countries like Germany or France where banks with very fragile balance sheets have large exposures to sovereign debt from Southern Europe and/or to bank debt from Ireland and Spain. These three crises are entangled with each other, and it is difficult to disentangle them.

The difficulties came into evidence after the Deauville meeting of Merkel and Sarkozy when they announced that, in the future, under the successor to the EFSF, any support of sovereign debtors would require a bail-in of creditor banks. Merkel and Sarkozy thought that they were just talking about the future, a regime that was to be imposed after 2013. But they forgot that, as of now, there are outstanding bonds that will mature in 2020. Would such bonds benefit from a grandfathering clause? Or would the bondholders be subjected to the bail-in requirement after 2013? Just raising the question creates unrest for today's financial markets – and for the German and French banks that may be holding such bonds. And what about debt that will be maturing in 2012? This debt will have to be refinanced, perhaps by issuing new debt with a maturity extending beyond 2013. Conditions under which this debt can be issued in 2012 will depend on prospects for how this debt will be treated after 2013. These conditions in turn affect how today's holders of debt maturing in 2012 assess the prospects of actually receiving their dues. These consider-

ations show that it is difficult to even talk about proper governance post-2013 while we must be afraid that the effects of such talk will disturb today's markets and deepen the triple crisis that we have.

Following the markets' reactions to the Deauville announcement, EU finance ministers tried to quiet the markets by saying that bail-ins would only be required when a debtor were to have a solvency problem. For support with liquidity problems, no bail-in would be required. To me, this is another example where concern about the current mess precludes a sensible discussion of future governance. From a debtor's perspective, the problem is always just a liquidity problem. And the private creditor will agree if that helps him avoid a bail-in. If you think about the substance of the matter, you will notice that, for sovereign debt, the concept of insolvency as an objective inability to pay is not an operational concept. To assess a sovereign debtor's ability to pay, one would have to deal with questions like: What is the debtor country government's ability to get the country's elites to pay taxes? What is the debtor country government's ability to get a political consensus for selling assets? What is the debtor country government's ability to restrict public-sector salaries? These questions have played a key role in sovereign debt crises, in Weimar Germany as well as the Latin American countries in the eighties, in Greece and, to some extent, even in the United States today. Because these questions go to the core of what makes a national polity and society, I see no scope for providing "objective" standards for dealing with them. By relying on the non-operational distinction between insolvency and illiquidity, the finance ministers lay the foundations for bad governance in the future.

If we were able to clean up the current crises right away, we might be able to have a clean slate for discussion of governance after 2013. Unfortunately, this is not very likely. To some extent, this is a matter of technical and legal problems. More importantly, there is no political will to clean things up right away. On this point, Germany bears much responsibility. From the very beginning of its intervention in the financial crisis, in October 2008, the German government has been bent on preventing transparency about the costs of intervention by shifting risks into the future. In October 2008 and the following

months, support was mainly provided in the form of guarantees. As we all know, guarantees do not cost anything, and they do not have to be put on the budget. The "bad bank" law in 2009 allowed banks to place dubious assets with the government. The government takes current write-offs (or not) on these assets, and a reckoning with the banks is deferred for twenty years. The support package for Greece and the EFSF have the great advantage that you do not have to tell the taxpayers that you are bailing out banks again. The advantage is all the greater if you can say that you are just dealing with a liquidity problem and no taxpayer money will be lost. I am afraid that, as long as there is no change in attitude concerning the costs and benefits of transparency, we will not be able to clean up the system, and discussions about governance after 2013 will be contaminated by all three of the crises that we have right now.

In this context, it is not helpful that so much of the political discussion last year has been formulated in terms of solidarity and in terms of a currency crisis. There has been a lot of discussion of the sort that if it was not for Greece or Spain, German exports would not be doing as well as they are. Therefore, Germany should feel an obligation to support the peripheral countries with their debt problems. The story can also be told in another way: If it had not been for European Monetary Union, the interest rate premia for the peripheral countries' sovereign debts would probably have remained where they were prior to 1995, which, except for Greece, is twice as much as what they have become *after* the crisis – and a large multiple of what they were before 2007! And Germany would have had a higher real investment and higher real growth in the first half of the decade. This part of the story should presumably be part of the solidarity equation as well.[2]

More importantly, talking about these matters in terms of solidarity creates significant political risk. Solidarity is a big word which means different things to different people. For a government to use taxpayer money in the name of solidarity, there must be some acceptance of this solidarity among the electorate. In this respect, there

2 H.-W. Sinn, Rescuing Europe, CESifo Forum 11, Special Issue, August 2010, W. Franz, C. Fuest, M. Hellwig and H.-W. Sinn, A Euro Rescue Plan, CESifo Forum 11, No. 2, 2010, pp. 101–104.

are significant differences across countries, even for solidarity within the country itself. Outside of certain political and intellectual elites, there is as yet little acceptance of any general notion of cross-border solidarity within the European Union. Public political discussion in the European Union mostly takes place along national lines. Within the different national discourse communities, notions of solidarity towards other nations tend to be seen with suspicion. The European Union is seen as a mechanism that siphons off money from national uses. The turbulence of last year's discussions has very much reinforced these suspicions. We may deplore the populism that we see in these debates, but we should not underestimate the risk of an uncontrollable political backlash – in all affected member states. In this respect, the open disrespect for existing law that has been shown by many participants has been very harmful. So has been the lack of transparency about who is being supported, public employees in Greece taking early retirement or German and French banks avoiding significant write-offs.

The discussion has also not been helped by euro-skeptical journalists and populist politicians interpreting the crisis as a currency crisis. The crisis is *not* a crisis of the euro and its internal or external stability. The internal purchasing power of the euro has not been affected. The external purchasing power of the euro has declined somewhat in the spring of 2010, but the devaluation *vis à vis* the dollar was hardly more than a correction of an excessive revaluation in the years 2002 – 2009, excessive that is, relative to differences in inflation rates. Journalists and politicians like to tell stories about such exchange rate movements, but there is no story to be told. Movements like the ones we have seen have been a recurrent phenomenon since the reintroduction of flexible exchange rates in the seventies, and for most of them we do not have any explanations. (I also would not wish to refer to the subsequent revaluation of the euro vis à vis the dollar as an indication that the crisis has been overcome.)

As for the governance of the euro, I appreciate that, over the past year, there has been a lot of controversy about the behavior of the ECB. However, I do not see this development as running counter to the depoliticization and professionalization of the debate about

monetary policy that I had observed in previous years. The discussions that we have had about ECB policy during the last year and a half have mostly not been about issues of independence of the central bank or about the responsibilities of the ECB for the overall economy. These discussions have been narrowly focused on how the ECB should deal with the crisis. Leaving aside the legal question of whether the ECB's decisions and policies are compatible with the Treaty, I believe that most of those discussions can be interpreted as instances of reasonable professional dissent in central banking. Thus, I do not see the ECB as having been captured by President Sarkozy or any other head of government or head of state.

There is a lot of criticism against the ECB buying up all sorts of things, including strange assets, toxic assets, etc. I have no idea what the quality of these instruments are but I have been thinking that, if the losses are there anyway, they have to be borne by someone and, if the banks that invested in these instruments are unable to bear them, then using seigniorage to cover these losses may not be the worst idea. I do, however, fear that if political systems or financial systems get used to the ECB solving their problems, then using seigniorage to underwrite losses on poor investments will end up being a very bad idea indeed. This is precisely why I believe that we need to think about what an appropriate and credible governance system for the period after 2013 would be.

3. Underlying Problems That Must Be Addressed

The preceding remarks indicate why the current crisis is so serious and why it is so difficult to get out of it. I now turn to the issues that we need to think about when we ask what would be a good system of governance for the future. In so doing, I will make believe that the problem of transition out of the current crisis can be ignored and proceed as if we could start with a clean slate.

If we think about what actually went wrong over the last decade, we must be concerned about the implications of the lack of an exchange rate mechanism for capital flows and for governance in the euro area. In providing a fairly sanguine assessment of European Monetary

Union in 2006, I very much underestimated this problem.
We have a common currency, but *not* a common price system. Markets are not integrated to such an extent that regional and national price movements are as highly correlated as they would be in a single sovereign region or country. Year by year, the variance of inflation rates across the different member states of Euroland is much higher than the variance of inflation rates across American states, Swiss cantons, or German Länder. If exchange rates were flexible, these differences in inflation rates would by and large be reflected in exchange rate movements. Anticipation of exchange rate movements would force nominal interest rates to be different in different countries.

In a currency union, however, the exchange rate is fixed, and there is no reason why borrowers in different countries whose credit risks are similar should be charged different nominal interest rates. When nominal interest rates are the same, however, differences in inflation rates induce differences in real interest rates. In countries with higher inflation rates, real interest rates are lower, and, *ceteris paribus*, investment demand will be higher. Higher investment in turn boosts aggregate demand, which contributes to rising prices. Some of the capital flows that we have seen in the years before the crisis reflected these differences – in inflation rates, real interest rates and investment demand – and reinforced them. Thus funds flowed from countries like Germany, where inflation was much below the average and therefore real rates were higher, to banks – and ultimately real-estate investors in countries like Ireland and Spain where inflation rates were higher and real interest rates accordingly low. For public debtors in the peripheral countries, there also was the temptation to borrow more as entry into the European Monetary Union had eliminated the high risk premia that they had had to pay in the past.[3]

I am not concerned about these capital flows *per se*. As a consequence of monetary union, some such capital flows were to be expected – and were fully intended. Previous interest rate differentials had been very high and had contributed to preventing capital from flowing to destinations where it would be most productive. After all, these interest rate differentials contained not just the premia for expected

3 On this argument, see again Sinn (fn. 2) and Franz et al. (fn. 2).

differences in inflation rates or expected exchange rate movements, but also the premia for the associated exchange rate risks. Eliminating these impediments to the flow of capital would contribute to raising welfare in countries receiving these flows and putting them to productive use as well as providing returns for investors in countries with surplus savings.

However, governance mechanisms for these capital flows were insufficient. Capital flows to banks in Ireland and Spain took too little account of the dangers inherent in the Wicksellian dynamics of real interest rates, investment and housing price appreciation generating a bubble. In Greece and Portugal, there was too little concern about fiscal sustainability. In both contexts, there was a lack of discipline, on the side of lenders as well as borrowers.

This lack of discipline was to some extent due to the lack of an exchange mechanism. For a country that has its own currency, the exchange rate typically provides a disciplining mechanism. This mechanism may work because it goes against the country's pride to see the exchange rate devalued, and therefore policies that destroy the international competitiveness of important industries may come to be questioned when the loss of competitiveness affects the exchange rate. Or it may work because lenders distrust the country government's ability to finance its activities without using the printing press and therefore refuse to lend in the country's currency, a constellation which Eichengreen and Hausmann have called *original sin*.[4]

Many argue that, if only Greece or Portugal had been able to borrow in their own currency, they could now devalue their currencies and they would be fine again. Arguments get the matter backwards. If these countries still had had their own currencies, they would not have been able to borrow in their own currencies in the first place, at least not to the same extent and at the conditions that they actually got. Given the constraints on domestic-currency borrowing, they might have borrowed in foreign currencies, but, as they did so, they would have had to consider the risks inherent in such borrowing.

4 B. Eichengreen and R. Hausmann, Exchange Rates and Financial Fragility, in: Federal Reserve Bank of Kansas City, New Challenges for Monetary Policy, Kansas City 1999, 329 – 368.

With significant foreign-currency-denominated loans outstanding, they would have to consider that a devaluation of the currency would not only restore the international competitiveness of some industries but also inflate the value of their foreign-currency-denominated debt in terms of the home currency. The experiences that Latin American countries have gathered over the past three decades with different exchange rate policies provide ample warnings. None of them has been able to eliminate the consequences of original sin, the inability to borrow freely in one's own currency and the risks inherent in foreign-currency borrowing.

In Euroland the disciplining mechanisms that are based on exchange rate movements and exchange rate risks are missing. On the one hand, as mentioned, this reduces frictions and enhances efficiency in cross-border capital flows. On the other hand, it increases the temptation for sovereign borrowers and their lenders to neglect fiscal sustainability.

Fiscal sustainability, fiscal discipline and a respect for (intertemporal) government budget constraints are important because each member state government is in principle independent and sovereign in its own fiscal policy. This independence is the only way to accommodate the very different attitudes towards fiscal policy and, more fundamentally, towards the role of the state that we have in different countries. For instance, the UK has a very strong market orientation in economic policy, the French government a very strong desire for state control over the economy. (Germany is somewhere in between, in principle very market oriented but in the details sometimes quite interventionist.) These differences induce difference in the extent to which economic fluctuations put the government at risk. It would be difficult to put the implied fiscal policies under a common set of principles.

Differences in attitudes towards the role of the state also concern the question how much society, and in particular the social and economic elites, are willing to pay for the state. In the case of Greece, as in Latin America three decades ago or Weimar Germany in the twenties, we are not just talking about an external transfer problem; we

are also talking about an internal transfer problem due to the unwillingness of significant parts of society to contribute to government finance.[5] In this context, of course, we also must take account of the expensive monuments that statesmen like to build to themselves, Olympic Games and the facilities that they require, or certain kinds of industrial policy, industrial policy as a disguise for social transfers or industrial policy as a realization of economically unviable technical dreams like the Concorde.

In all these issues, political legitimacy is derived from national political discourse. EU interference is resented and cannot be taken too far. Therefore, it is all the more important for participants in national discourse to be aware of the fact that the government is subject to a budget constraint, and that the presumed benefits of certain policies and certain monuments must be compared to their costs. In this respect, the elimination of a disciplining mechanism for government borrowing is very problematic.

The Stability and Growth Pact should have provided for such a mechanism, but in the early 2000's, Germany and France prevented its application because their governments considered the Pact to be an infringement of their sovereignty. This experience carried a more general lesson, namely, arrangements for imposing fiscal discipline will not work if the parties whose job it is to enforce them are not interested in doing so. This was true of the Council with the Stability and Growth Pact. It was also true of the Commission with the No-Bail-Out Clause of the Maastricht Treaty. In last year's crisis, the Commission had nothing to gain by fulfilling its official role as a guardian of the Treaty. In contrast, it had a prospect of significantly enlarging its own turf by working towards a new regime that would provide for inter-state bail-out in the European Union. Given these experiences, I find it remarkable that negotiations about future

5 On the internal transfer problem in Latin America in the eighties, see H. Reisen and A. v. Trotsenburg, Developing Country Debt: The Budgetary and Transfer Problem, Development Center Studies, OECD 1988, on Weimar Germany, see H. James, The German Slump: Politics and Economics 1924 – 1936, Oxford University Press, Oxford, 1986, and S. Schuker, American "Reparations" to Germany, 1919 – 33: Implications for the Third-World Debt Crisis, Princeton Studies in International Finance No. 61, 1988, International Finance Section, Princeton University, Princeton, N.J. 1988.

governance have completely neglected the problem of credibility.[6] Ever since Deauville, we have been en route towards a Stability and Growth Pact 2, which is going to have the same governance problems as its predecessor.

Current discussion focuses on "competitiveness". As far as I can tell, this is a weasel word that makes believe that EU institutions are addressing the issues when, in fact, the meaning of the word is not clear. In the present context, it might be deemed to concern the problem that higher-than-average wage and price inflation in a member state erodes the ability of firms in that state to compete in domestic, EU and world markets. This problem is associated with the kind of Wicksellian dynamics that I mentioned above, where differences in inflation rates induce differences in the real rate of interest, which then drive capital flows. This being said, I fail to see what policy interventions would be called for and what policy instruments would be used to deal with such developments. (Remember that wage setting mechanisms are quite different in different countries.) Nor do I see how EU institutions would induce member state governments to actually intervene. I therefore suspect that word itself is a device used to hide the fundamental dissent between different member states as to what the economic coordination mechanism should be that the Council is presumably looking for.

Coming from a background in microeconomics and competition policy, I feel very uneasy about the word "competitiveness" because it has been abused so much. When a politician uses the word "competitiveness", he usually means that he wants his country's "champions" to conquer the world. For this purpose, he does not mind subsidizing them with taxpayer money or giving them a monopoly position at home as a generous source of finance. Having observed Mr. Sarkozy in his previous incarnation as Minister of Finance at the time of the Sanofi-Aventis merger, I know that this is his mode of thinking. I am therefore concerned that a governance arrangement focused on "competitiveness", which makes sense in some macro settings where you are talking about wages being set semi-exogenously through collective bargaining or through the government providing

6 This point is already raised in Franz et al. (fn. 2)

a benchmark, may end up being intermingled with particular notions about microeconomics and competition policy, in an attempt to get the rest of the European Union to adopt a form of industrial policy which, for France, has been very costly, one of those monuments that politicians like to build for themselves.[7]

So far, I have only talked about the problem of fiscal discipline on the side of the borrower. What about the lenders? The Wicksellian dynamics to which I pointed were driven by differences in real rates of interest that are induced by differences in inflations rates when nominal rates of interest are the same. But, why should nominal rates be the same? Why should we take it for granted that interest rates on Greek government bonds ought to be (almost) the same as interest rates on German government bonds? If fiscal sustainability in the different countries is different, nominal interest rates should be different. Yet, prior to the crisis, differences in nominal interest rates for different member state governments were negligible. Were there no reasons to believe that default risks differed? In my 2007 paper, I observed that the failure of financial institutions and financial markets to take account of the fact that different sovereign borrowers had different fiscal capacities represented an anomaly.

The anomaly can now be explained. Market participants gamed the system, and they seem to have been right. Of course I am just speculating here about what bankers thought in 2001, 2002, and so on. They might just have been dumb and not appreciated that the different member states differed in their ability to pay their debts. But they might also have been very clever and anticipated that the Maastricht rules were not going to withstand the pressure of a crisis. If this is what they thought, they were right, at least so far. They may yet be proved to have been wrong if the debts they hold will be subjected to haircuts after all. However, the very weakness of the banks in the wake of the subprime-mortgage crisis provides a strong reason why governments have shied away from such haircuts.

7 For a comprehensive discussion, see Monopolkommission, Wettbewerbspolitik im Schatten „Nationaler Champions“, XV. Hauptgutachten 2002/2003, Nomos-Verlag 2005, pp. 21 – 28; English translation of an abbreviated version pp. 575 – 585.

If we want the lenders to take a part in imposing discipline on borrowers, we need to have bail-ins in the future. On this point, however, we should not deceive ourselves. There has been a lot of talk, but as yet no scheme that I would consider to be credible. If a new treaty this year or next year stipulates bail-ins of creditors in future debt crises, I expect that, if by 2020, we have another debt crisis and the solvency of banks is at risk, the bail-in clauses that are agreed now will be found to be just as good as the sanctions mechanism of the Stability and Growth Pact or the no-bail-out clause of the Maastricht Treaty. Moreover, the banks will know this, and, given the experience we have just had, they will be confident about their ability to "convince" the European Union and its member states that the application of bail-in clauses in a crisis is likely to have dire consequences.

4. Some Recommendations

In thinking about future governance, we must above all worry about the credibility of the regime we install. There is no foolproof recipe for doing so, but some improvements over the current regime – and current plans should be possible. Most importantly, we should begin to think about banks, their behavior and their governance, as part of the problem of Euroland governance. Until now, discussions about banking systems and discussions about Euroland governance have been treated as if they were completely unrelated. I consider this separation of the two sets of issues to be a big mistake. We need to integrate the discussions of the governance of the banking system with the discussion about how to reform the Euro system. In the following, I formulate a few recommendations in this direction.

Recommendation 1:
Whatever governance mechanism is set up to discipline fiscal policy should be sensitive to information about the country's banking system.

This recommendation is based on the observation that fiscal problems in Ireland and Spain have not arisen from unsound fiscal policies but from unsound banking practices, in combination with a too-big-to-fail or a too-political-to-fail approach of the government. By

the terms of the Stability and Growth Pact, Ireland and Spain were doing wonderfully even as the risks were building up. The problems that caused the Irish situation to blow up and that are still causing significant pressure for Spain never even appeared on the radar screen of the Stability and Growth Pact. Given that banking systems can be too political to fail and given that bank bail-outs may overtax the national taxpayers, institutions observing fiscal sustainability should have an eye for banking developments and the fiscal risks they imply. In my opinion, this matter is not being given enough attention.

Recommendation 2:
Make bank supervisors independent.

Traditionally, banking supervision has been treated as a national prerogative, usually in the domain of the finance minister. In the past, I have supported this arrangement on the grounds that, with too-big-to-fail policies, ultimately, the risks of poor banking supervision are borne by the taxpayer. If we look at the actual record, however, for how banking supervision has done under the authority of finance ministers, I find that there is a good case to be made for independence. In the years prior to the crisis, governments have been more concerned about not throwing sands into the wheels of "their" banks than about protection of taxpayers from the fallout of the risks that these banks assumed. This has been the case in Ireland, where the government and the supervisors did not want to damage the ability of Irish banks to get funds from abroad. This has also been the case in Germany where the government and the supervisors did not want to interfere with the ability of the Landesbanken and of the real-estate-finance institutions to earn money abroad. In both cases, taxpayers were not served well by government use of authority over banking supervision. The rationale for this authority is thereby undermined.

Underlying these failures is the deeper problem that politicians and governments tend to look at banks as a source of funds rather than a source of risks. When this attitude prevails, they are more concerned about getting the banks to fund close to the politicians' hearts than about getting them to avoid risks that might be costly to the taxpayers. Whereas, in theory, supervision under the authority of the

finance minister reflects the potential involvement of taxpayers in bailing banks out, in practice, it may provide the basis for a symbiosis of governments and banks, where banks provide funds for certain activities and governments protect the banks from excessive competition. Before the deregulation of the seventies and eighties, there were many regulations that explicitly called for bank funding of specified activities, with highly adverse effects on the risks to which banks were exposed, while government guarantees as well as restrictions on competition in banking provided the banks with rents. Examples are geographic restrictions on mortgage lending (Texas), very high minimum reserve requirements (Portugal), requirements to invest in government bonds (Sweden). The symbiosis thrived on the lack of transparency about the costs of political intervention and the lack of transparency about the risks to which banks were exposed.

Even after the financial crisis, the underlying attitude is still there. Discussions about Basel III were dominated by banks claiming that sharper regulation would induce a credit crunch, as if a lack of funding possibilities had been a key characteristic of the past decade. The German government was most concerned about preserving the status of public-sector banks in Germany, among them the main culprits in the crisis, with estimated costs to the taxpayer in the range of 50 bn. to 150 bn. EUR. Given the observation that, in practice, governments are not much concerned with risk from their banks and that prudential supervision is often blunted or even abused for political purposes, the theoretical case for putting banking supervision under the authority of the government seem practically irrelevant.

Recommendation 3:
Strengthen the competences of European supervisory institutions and of European networks of national supervisors.

I have two reasons for this recommendation. First, the Irish experience shows that banking supervision at the national level can have significant repercussions for other member states of the European Union. Charles Goodhart's saying, "Banks are international in life,

but national in death", does not quite fit the Irish experience.[8] In Euroland today, the costs of bank bail-outs are not just borne by the national taxpayer but by taxpayers all over. This suggests that national banking supervision should be subject to some co-ordination and control at the supranational level.

Second, I believe that the problem of regulatory capture is reduced if we have a network of bank supervisors acting in co-ordination but with some degree of independence. Something like this has been observed in competition policy for network industries such as telecommunications or electricity. Here, the workings of the European networks of national regulators have reduced the amount of capture by comparison to what we had before, largely, I believe, because each regulator could point to regulators in other countries as benchmarks. Just as importantly, the desire to be accepted by one's peers at the European level has affected the motivation of sector-specific regulators.

A final point: I would not wish to have banking regulation integrated into the central banks. In the crisis, it did not make much of a difference whether a country's supervisory authority was integrated with the central bank or not. This suggests that this question is of little consequence for the performance of banking supervision. However, the American experience shows that, if banking supervision and monetary policy are under the same roof, the integrity of monetary policy can be compromised by concerns about financial institutions. Such a development can lead to bad monetary policy. It can also become a source of moral hazard as the financial industry develops a sense that, if they get into trouble, the central bank will bail them out. There should be transparency in the sense that supervisors should know where monetary policy is going and the central bank should know what the state of the financial system is, but the different functions should not be under the responsibility of the same institution.

8 C.A.E. Goodhart, "Procyclicality and financial regulation," Banco de España, Estabilidad Financiera 16 (2009), p. 16. Goodhart puts the formulation in quotation marks, perhaps in deference to Mervyn King's "global banks are global in life but nation in death", for which, unfortunately, I have not found a reference.

6
Sovereign Debt and Banks: Need for a Fundamental View on the Structure of the Banking Industry

Arnoud W.A. Boot

The credit crisis has made us all aware of the fragility of banks, and the financial sector at large. These very same banks also show up in the Euro sovereign debt crisis. EU banks outside Greece, Portugal and Ireland may own a few hundred billion euro's of the total outstanding public debt of those three countries. Any debt restructuring will therefore have serious consequences for the balance sheets of those institutions. For EU (and Euroland) policymakers this has further complicated their decision making on the financial problems of some of the member states.

Debt restructuring – possibly in all three countries – might be inescapable. Since many of the banks that hold the sovereign debt will be considered systemic in their home country, the countries involved might feel compelled to help these banks deal with the losses on the sovereign debt that restructuring implies.

A key concern is with the size of domestic financial sectors. This

particularly applies to many EU countries where the total balance sheet of the domestic financial sector often is a staggering multiple of the national product of the country. Moreover, there exists no mechanism for burden sharing in case of failure of EU-wide operating banks. In case of a failure of a bank, its home country is essentially left on its own. Also this complicates a debt restructuring: no real EU-level procedures are in place to deal with failing banks. While some improvements are being made in EU level supervision (based on the 2008 de Larosière Report), the EU level arrangements cannot do much more than provide for some coordination. No burden sharing is in place and national supervisors remain in charge together with the national Ministries of Finance (for dealing with the potential financial consequences).[1]

Against this backdrop strengthening the resilience of the financial system is a paramount concern. In my view we need to deal with the complexity of the financial sector, and measures affecting the structure of the industry might have to be taken. Let me offer some thoughts on how to deal with the complexity of financial institutions.

Dealing with size and complexity: breaking-up banks and living wills[2]

The issue of complexity of financial institutions is heavily debated. In other industries one is tempted to say that market forces will figure out what the optimal configuration of a firm might be (subject to anti-trust concerns). However, in banking complexity can induce and worsen externalities that one might want to contain. More specifically,

i. complex institutions might be difficult to manage and supervise, and effective market discipline might not be expected (problem of opaqueness);
ii. a complex financial institution may have many, difficult to

1 At the EU level European Supervisory Authorities are being created, including the European Systemic Risk Board. Some exposure on sovereign debt is being assumed by the European Financial Stability Facility as well as the ECB.
2 Adapted from my paper "Banking at the Crossroads: How to deal with Marketability and Complexity?", prepared for the April 5-6, 2011, FED Atlanta 2011 Financial Markets Conference, Navigating the New Financial Landscape.

discern linkages with the financial system at large. This may augment TBTF, or rather too-interconnected-to-fail concerns;

iii. as a consequence systemic concerns might become more prominent;

iv. complexity might paralyze supervisors and put them in a dependent position; e.g. how is timely intervention possible if the complexity of the institution cannot be grasped by supervisors?

On the latter point, one element of the current reform proposals asks financial institutions to have a living will available, i.e. a detailed recovery and resolution plan that would allow for an orderly and efficient resolution of financial difficulties when they may arise. Such a living will aims at overcoming the complexity of an institution, and the paralysis it may cause with the supervisor when problems emerge. Taking this concept seriously should probably mean that all relevant financial institutions organize themselves in a way that they can be easily dissolved when problems arise. So the complexity might have to be dealt with upfront, and would then have direct implications for the organizational structure of the business, i.e. for a bank's business model.

One is tempted to conclude that one way of dealing with the complexity is to disentangle activities and put them in separate legal structures ('subsidiaries'). Those subsidiaries could deal on an arms-length basis with each other, with each being adequately capitalized without recourse on each other. This would resemble the non-operating holding company structure that is discussed in some OECD studies. With such a structure supervisors could possibly more easily (and timely) target, i.e. rescue, systemically important parts of a financial institution in case of distress; other parts could be sold or dismantled.

In this spirit one could look at the arrangements in New Zealand. In that country much of the banking system is in the hands of foreign players. New Zealand's authorities were skeptical about this lack of control, and instituted structural requirements to address them. The

requirements entail enforced organization of activities within subsidiaries, but on top of that requirements that make the New Zealand based subsidiaries operationally independent from their foreign parents. Without effective pan-European arrangements, this might be necessary for individual EU countries to contain risks.

Can separate legal structures under one corporate roof be effective?

Whether such separate legal structures are really effective is unclear. In the market there might still be reputational spillovers between the different parts. Similarly, the market may still expect intra-group cross subsidization or joint risk bearing with the group's financial strength being perceived behind any individual activity.

In practice, financial institutions typically have corporate structures that include a myriad of legal entities. It cannot be emphasized enough that banks in this way have become horrendously complex. HSBC for example has in excess of two thousand entities. These are typically not designed to augment transparency and/or reduce complexity, but rather to engage in regulatory arbitrage (e.g. capital management) and economize on taxes. The legal structures themselves are typically not stand-alone in any meaningful way but linked together through intra-group transactions, joint back offices and other shared facilities and activities. While these interlinkages might help in obtaining synergies, the complexity that comes with it seems at odds with having effective living wills, or having a business structure that is receptive to supervision or market discipline.

Complexities are even more magnified once we take into account cross border activities and differences in bankruptcy regimes across countries. Potential conflicts are enormous in case of a crisis considering problems associated with burden sharing. Note that living wills and the timely intervention they could facilitate might be really valuable in these cross border situations especially when intervention occurs before losses become overwhelming.

One may expect that the industry will vigorously oppose such transparent and arms-length structures that – in their view – would limit

synergies. The incentives of financial institutions might also be to seek complexity and in doing so hold supervisors 'hostage.' The implicit TBTF (or too-complex and/or interconnected-to fail) backing may further amplify disagreements between the bankers privately optimal choices and those of society. The reality is that the non-operating holding company structure as envisioned in the OECD studies – with transparency via arms-length contracts, no recourse and separate capitalizations – is a far cry away.

Breaking up banks?

A valid question is whether in face of this opposition one should not be more active and possibly go for a more radical break-up scenario. This refers to structural measures that seek to prescribe the structure and allowable businesses of banks and other financial institutions. Several policymakers have advocated such measures. The British have arguably been most adamant. Both Mervyn King (Governor Bank of England) and Adair Turner (Chairman of the Financial Services Authority) have both hinted at the need to split up banks. However, the UK Independent Banking Commission (the 'Vickers Committee') seems to shy away from break-up scenarios.

If the complexity makes it impossible for supervisors to (credibly) intervene in a timely fashion, one may start thinking about the desirability of breaking-up banks. One question is whether this is really possible. And the other is how breaking-up banks squares with the broader objectives of supervision, and particularly the lessons learnt from the financial crisis. At least two lessons could be identified:

- Contagion should be addressed;
- Core commercial banking functions might have to be safeguarded.

The latter typically refers to the payment system and local deposit and lending operations. If a break-up indeed increases transparency and reduces complexity, timely intervention might become easier and this could help serve both lessons.

What to do?

In my view the complexity of banks together with the sizable risks that banks impose on the economy at large (and EU countries in particular) necessitate actions that simplify the structure of banking institutions. With the enormous complexity of existing institutions and the difficulty that regulators (and legislators) have in grasping the intralinkages (within) and interlinkages (across) financial institutions, much could be gained. Also, well known problems like how to deal with the cross border operations of banks (international co-ordination) and the shadow banking system at large would need to be addressed.

What does not help is that there are no well established prescriptions on how to go about redesigning the financial architecture. Hopefully, for the foreseeable future, the design of the financial system will (continue to) be high on the research agenda of academics as well as regulatory and other public bodies.

7
Greek Debt -- The Endgame Scenarios

Lee C. Buchheit & Mitu Gulati

At about this time last year, we wrote a short paper entitled "How to Restructure Greek Debt."[1] The intervening months have seen the following major events in the Eurozone debt crisis:

- In May 2010, Greece concluded an agreement with the Eurozone member states, with the backing of the IMF, for access to a €110 billion facility (€80 billion from the Eurozone and €30 billion from the IMF).[2] That amount was judged to be sufficient to allow Greece to repay -- in full and on time -- all public sector debts maturing during the three-year IMF program period and to cover anticipated budget deficits during that period. One objective of this total bailout of Greece was to staunch any risk of contagion to the other European peripheral countries.

1 Available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1603304. The published version of this paper can be found at Lee C. Buchheit & Mitu Gulati, Restructuring a Nation's Debt, Int'l Fin. L. Rev. 46 (June 2010).
2 See Ronald Janssen, Greece and the IMF: Who Exactly is Being Saved? CEPR Draft (July 2010) (available at http://www.cepr.net/documents/publications/greece-imf-2010-07.pdf).

- The European Central Bank promptly embarked on a program of open market purchases of Greek and other Eurozone periphery debt in order to "ensure an orderly monetary policy transmission mechanism."[3] This program continues, in fits and starts, as of this writing. The ECB is thought now to own €40-50 billion of Greek sovereign bonds purchased in the secondary market.

- On October 18, 2010, German Chancellor Angela Merkel and French President Nicholas Sarkozy took a stroll on a beach in Deauville, France. When they returned holding hands (in a figurative sense, naturally), they announced plans to alter the EU treaty to put in place a permanent "crisis management system" that would include provisions to ensure the "adequate participation of private creditors".[4] Unfortunately, Mr. Sarkozy and Mrs. Merkel did not confide to the markets precisely what this "adequate participation" entailed. Predictably, the markets assumed the worse, resulting in a sell-off of Eurozone periphery sovereign debt.[5] Yields on that paper moved sharply higher.

- In late November 2010, Ireland asked for, and received, its own €85 billion bailout package, also with IMF conditionality.[6]

- To calm the markets after the Deauville adventure, the finance ministers of the five biggest EU member states announced on November 28, 2010 that "any private sector involvement [in Eurozone sovereign debt restructurings] …

3 See Ansgar Belke, Driven by the Markets? ECB Sovereign Bond Purchases and the Securities Market Program, Directorate General for Internal Policies, Working Paper (June 2010) (available at http://www.europarl.europa.eu/document/activities/cont/201006/20100610ATT75796/20100610ATT75796EN.pdf).
4 See Erick Nielsen, Eurozone Bond Haircuts Must Look Appealing, Financial Times, November 9, 2010.
5 See Peter Spiegel, Anger at Germany Boils Over, Financial Times, November 16, 2010; Simon Tilford, Eurozone Politicians are Playing with Fire, CER Insight, November 15, 2010.
6 See Ian Traynor, IMF and EU bail out Ireland amid fears of Eurozone contagion, The Guardian, November 22, 2010.

would not be effective before mid-2013".[7] In other words, investors were assured -- or thought they had been assured -- that all existing Eurozone sovereign debt instruments would be immune from a debt restructuring.

- On March 8, 2011, Greece filed a registration statement with the U.S. Securities and Exchange Commission enabling the country to issue bonds to "diaspora" Greek investors at rates significantly below market.[8]

- On April 6, 2011, as this paper was being written, Portugal asked the European Union for financial assistance.[9]

- March 23, 2011 saw the release of a term-sheet for a permanent facility to assist distressed Eurozone sovereigns after 2013, the European Stabilization Mechanism ("ESM"). The term sheet makes clear that ESM loans will be given preferred creditor status.[10] A similar claim to preferred creditor status has not been made (or at least not yet been made) for the €80 billion EU contribution to the Greek bailout package.

- Last month, the Greek Finance Minister said publicly that even the €110 billion EU/IMF facility might not be enough to tide Greece over until 2013.[11]

To date, one or more of the following concerns about permitting a restructuring of Eurozone sovereign debt have induced the official sector to continue a policy of total bailouts of all afflicted countries.

7 Statement by the Eurogroup, available at http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/118050.pdf
8 A Greek Diaspora Bond Odyssey, Financial times (Alphaville), March 9, 2011 (available at http://ftalphaville.ft.com/blog/2011/03/09/509211/a-greek-diaspora-bond-odyssey/).
9 See Peter Wise and Peter Spiegel, Portugal appeals for EU bail-out, Financial Times, April 7, 2011.
10 See The Eurozone's ESM Permanent Bailout Fund, Financial Mirror, March 23, 2011 (available at http://www.financialmirror.com/Columnist/Global_Markets/752).
11 *Id.*

- **Contagion.** Confronted with a debt restructuring in one country, will the markets recoil from all peripheral Eurozone countries, perhaps sparking a general crisis?

- **Effect on banks.** Eurozone commercial banks hold the lion's share of Greek sovereign bonds. A debt restructuring that significantly reduced the balance sheet valuation of these assets could threaten the solvency of some institutions, perhaps requiring a recapitalization from the host government.

- **Honi soit qui mal y pense.** Would a Eurozone sovereign debt restructuring indelibly stain the reputation of the Euro and perhaps even undermine the foundations of the monetary union itself?

Although each of these constraints is still present to some degree one year after the Greek debt crisis erupted, it is no longer obvious that they, individually or in aggregate, continue to justify complete paralysis. The markets have had an opportunity to focus on the differences in the financial positions of the various peripheral Eurozone countries. Putting aside the obvious fact that the policy of total official sector bailouts has not prevented contagion (see Ireland and Portugal), blind indiscriminate contagion has diminished as a risk. As for the commercial bank holders, they have been given a year to sell or hedge exposures, or otherwise provision against an eventual hit to the value of their Greek positions. Some are no doubt still uncomfortably exposed, but this list should be smaller than it was a year ago. (It is not clear to us whether all banks have in fact made hay while this sun has been shining, but they have at least been given a chance to do so.)

We have now been asked to update our earlier assessment of the Greek debt situation in light of these developments. In particular, we have been asked to speculate on possible endgame scenarios for the Greek debt crisis.

We divide these scenarios into three groups: (i) Greece goes the distance with the current IMF/EU program and a debt restructuring is avoided altogether, (ii) a debt restructuring of some kind becomes unavoidable after June 2013 when the EU's "read my lips -- no restructuring until 2013" promise lapses by its terms, and (iii) a liability management transaction affecting some or all of the Greek debt stock is launched before 2013.

The Official Scenario -- Greece Goes the Distance

Under this scenario -- which enjoys the public support of Greece's official sector sponsors (the IMF and the EU) as well as the Greek authorities themselves -- Greece will stick with its program of fiscal austerity for the full three years. At the end of that period (apparently the initial prediction of renewed market access in 2012 has now been withdrawn), Greece returns to the capital markets to refinance its maturing debt and fund amortizations due on the EU/IMF bailout loans. The markets, this theory contends, will be so impressed with the turnaround in Greece's fiscal position that private sector monies will be advanced in sufficient quantities and at tolerable interest rates to permit Greece to resume normal rollovers of its maturing debts. Over time, Greece will run primary budget surpluses and will begin to nibble at its (admittedly) colossal debt stock. This, says the official sector, is the benignant future that awaits both Greece and all of its lenders.

The Risks

- On its current path, the Greek public sector debt in 2013 will represent 150-170% of GDP. Moreover, more than half of that debt stock will by then be in the hands of official sector creditors (the EU, the ECB and the IMF), at least one of which (the IMF) claims for itself preferred creditor status. Will the private capital markets really be eager to resume financing a country in this precarious position?

- Two more long years of fiscal austerity lay ahead for Greece. Will the Greek politicians be able to hold the social/political consensus together that long?

- What happens if Greece begins to miss its IMF performance targets? Will the IMF and EU casually relax the conditionality so that drawdowns can continue under the €110 billion facility, or might German parliamentarians insist on taking a harder line? Waiving compliance with the fiscal performance targets in order to avoid a debt default, of course, risks sending this message to other prospective borrowers from official sector bailout facilities: "Eurozone countries in financial distress can expect assistance from the EU and IMF in two -- but only two -- circumstances: (i) when those countries adopt and stick to stern fiscal austerity programs or (ii) when they don't".

- The €110 billion facility was intended by its authors to be an overwhelming demonstration of financial firepower -- a veritable Hank Paulson bazooka. If this was the antidote to contagion, however, it failed. Ireland has succumbed. So has Portugal. If one of these other countries decides to pursue a debt restructuring before 2013, might not that precedent fuel calls for something similar in Greece?

Post-2013 Scenarios

We see four possible scenarios if Greece is unable to regain market access in late 2013. Three involve a post-2013 restructuring of the Greek debt stock, while one envisions that Greece muddles on for an indefinite period as a ward of the official sector.

Scenario One: The Official Sector Takes the Spear. By June 2013, more than one-half of the Greek debt stock will be in the hands of official sector lenders. By significantly restructuring their own claims against the country, these official sector lenders could attempt to render Greece presentable to the private markets.

The Risks

- It is difficult (read, nearly inconceivable) to envision a political environment that would permit the EU and ECB -- much less the IMF -- to sacrifice their taxpayers' money in order to ensure full and timely repayment of commercial

creditors, some of whom are earning yields in excess of 12%.

- Will the EU carry the burden of such a restructuring alone, or will it expect the IMF to chip in? And if the latter, what, if anything, will be left of the IMF's sacrosanct "we never restructure" status?

Scenario Two: The Private Sector Creditors Take the Spear: Under this scenario, the holders of the remaining Greek debt stock still in private hands in mid-2013 will be presented with a restructuring proposal that effectively eviscerates the value of their paper.

The Risks

- Even a total write-off of that remaining one-third to one-half of the debt stock may not be enough to return Greece to creditworthiness.

- These creditors will never go gentle into the good night of a total loss of value. Something coercive, something truly ugly, will be needed to prod them into the abattoir. What effect would this have on future lending to Greece or, for that matter, to other Eurozone sovereigns?

Scenario Three: All Together Now. The third alternative involves a joint debt restructuring by both official and private sector lenders sometime after the middle of 2013. With private sector involvement, the official sector can't be accused of mollycoddling commercial lenders; with official sector involvement, those commercial lenders would not face a total write off of the value of their claims.

The Risks

- Some might argue that this demonstration of fraternal solidarity will only end up alienating the affections of both groups, the official and the private lenders. Would it not be better, they might argue, to keep one camp sweet for future borrowings?

- Unless the terms of the two restructurings were calibrated

to be equivalent in a net present value sense, this approach risks intercreditor jealousy and suspicion.

Scenario Four: Wardship. Perhaps the paralyzing fear of a Eurozone sovereign debt restructuring will persist even after 2013 has come and gone. If so, Greece could be relegated to the status of a ward of the official sector for an indefinite period. The remaining bonds in the hands of commercial lenders, and the amortizations due on the first round of EU/IMF loans, would presumably all be paid with the proceeds of drawings under successor official sector credit facilities. After the passage of a few more years, virtually all of the Greek debt stock will then be owed to its official sector rescuers.

The Risks

- This could be politically unpalatable to the Greeks. Someone is bound to say that when Greece took the first €110 bailout, this was equivalent to a bibulous landlubber accepting the King's shilling from the sergeant of a Royal Navy press gang in order to buy one more round of drinks: when the poor fellow wakes up in the morning he will be facing ten years before the mast in His Majesty's service.

- It can't be a very pleasant alternative for the official sector either.

Pre-2013 Restructuring Scenarios

If for any reason Greece cannot, or does not wish to, wait until mid-2013 before addressing its debt stock (a decision that presumably would require at least the passive acquiescence of the EU, the IMF and the ECB), broadly speaking we see two possible scenarios.

The EU's post-Deauville assurance that there will never be a restructuring of an existing Eurozone sovereign debt instrument (at least until 2013) presents something of an obstacle to any pre-2013 restructuring of Eurozone sovereign debt instruments. The face-saving solution may be linguistic. A voluntary liability management transaction undertaken by the debtor country before 2013, the argument

goes, is not a "restructuring" as that term was used in the post-Deauville assurance. Restructuring, it may be claimed, connotes a degree of coercion on the affected creditors. But if the creditors themselves elect voluntarily to participate in a liability management transaction to improve the creditworthiness of their debtor, who in the official sector can or should gainsay that decision?

Scenario One -- A Light Dusting. One possibility would be to approach the private sector (principally northern European commercial bank) holders of Greek bonds with a mild restructuring proposal that limits, or even neutralizes altogether, any net present value loss they would suffer as a result of participating in the transaction. A simple Uruguay-style[12] reprofiling of the debt stock with no haircut to principal would fit this bill. To ensure widespread creditor acceptance, some might urge that any new instrument issued to effect the restructuring benefit from credit enhancement (a partial guarantee from the official sector, for example, or collateral security à la Brady bonds) so as to neutralize the negative NPV consequences of the stretch-out of maturities. One obvious motivation for a mild restructuring of this kind would be to cushion its effect on the balance sheets of overexposed northern European commercial banks. A second motivation, of course, would be to move existing debt maturities beyond the current program period so as to liberate a portion of the €110 billion bailout facility for other purposes.

The Risks

- Will such a light dusting of the debt stock return Greece to a sustainable position, or will it be just the first of a two stage restructuring with the real blood-letting deferred to stage two?

- Neutralizing the negative NPV effect of a maturity stretch out by adding credit enhancements is expensive and contraindicated for a country facing a severe debt crisis. But asking bondholders voluntarily to accept an NPV loss, how-

12 In 2003, Uruguay "reprofiled" its external debt stock by extending the maturity of each of its 18 series of bonds by five years. There was no haircut to principal; coupons were kept the same. See Lee C. Buchheit and Jeremiah S. Pam, Uruguay's Innovations, 19 J. Int'l Banking L. and Reg. 28 (2004).

ever, will surely test the sponsors' powers of persuasion.

- Overexposed commercial banks that currently hold Greek sovereign paper in their "hold to maturity" book at or near par value may want an assurance that a transaction of this kind will not require an immediate marking of their positions to market values.

Scenario Two: The Full Monty. For the sake of completeness, the final option would involve a full restructuring of the Greek debt stock prior to 2013 in order to give the country a visibly sustainable debt profile as soon as possible. Such a restructuring would presumably look to cut the size of the debt stock in nominal terms as well as to iron out the maturity profile, all to the end of positioning Greece to return to the capital markets within a reasonable period of time following the closing of the transaction.

The Risks

- A Full Monty approach would require all concerned to jettison any illusions about sponsoring a wholly voluntary transaction.

- This will lead to the usual discussion about how -- in the odious patois of investment bankers -- to "incentivize" the bondholders to participate. Change local law to compel participation (more than 90% of the debt stock is governed by Greek law)? Threaten a payment default on any untendered bonds (the "abandon all hope ye who do not enter here" tactic)? Declare any non-tendered bonds ineligible at the ECB discount window?

- Having spent billions of Euros of taxpayer money to stave off any restructuring of Eurozone sovereign debt, will the political class in Europe really be prepared now to careen to the other extreme of countenancing a savage debt restructuring?

- A major tremor of this kind affecting the Greek debt would

indeed be felt in Lisbon, Madrid and elsewhere in peripheral Europe.

The Historical Perspective

We have all been here before.

In August of 1982, Mexico was forced to declare a moratorium on the repayment of its external debt owed to commercial banks. Over the course of the next two years, more than twenty other countries followed suit -- it later came to be called "the global debt crisis" of the 1980s.

Then, as now, the lenders to these sovereigns were primarily commercial banks. Then, as now, some of those banks were dangerously overexposed and could not have endured any significant writedown of the value of their sovereign credit portfolios. Then, as now, the banks approached the official sector institutions asking that the official sector either lend the sovereign borrowers the money to continue normal debt service on their bank credits or, failing that, guarantee the banks' loans.

Then, unlike now, the banks were rebuffed. The official sector flatly refused to bail the banks out of their bad credit decisions in the early 1980s. But, in recognition of the balance sheet fragility of some of those institutions, the official sector (and in particular the U.S. Treasury Secretary) agreed to use its influence over the sovereign debtors to promote a debt restructuring technique that avoided any need for the banks to write down the value of their sovereign portfolios.

This technique, later named after U.S. Treasury Secretary James Baker, had four components.

- The debtor country was required to sign up to an IMF stabilization and adjustment program.
- The principal of the banks' loans was rescheduled over relatively brief periods -- 18 to 24 months.
- Interest payments on those rescheduled loans, however, had

to be kept current to avoid negative accounting consequences for the banks.

- Because many countries lacked the resources even to pay interest, the banks were compelled to lend the debtors "new money" which was then recycled back to the banks as interest payments on their existing exposure.[13]

As the 1980s rolled sweetly on, the four elements of this Baker Plan debt restructuring technique were repeated, sometimes four or five times, in the afflicted debtor countries. In public, Secretary Baker and others expressed fathomless confidence that the banks would never experience a loss on their sovereign credits. Why? The debtor countries, it was predicted, would after years of IMF tutelage "grow" out of their debt problems. In private, however, the official sector players warned the commercial banks to begin provisioning their loan loss reserves against the possibility that a loss might someday materialize.

After seven years of the Baker Plan, a new U.S. Treasury Secretary, Nicholas Brady, announced (on March 10, 1989) a shift in U.S. Government policy toward the management of the global debt crisis. Secretary Brady encouraged the banks to write off a portion of their exposure to the debtor countries, and to stretch out repayment of the balance for 30 years, as a means of ending the global debt crisis in a single stroke. And, more or less, the Brady Initiative did just that. Banks swallowed (modest) losses on their sovereign portfolios; debtor countries regained (modest) market access; the banks' loan loss reserve provisions (built up over the prior seven years) cushioned the balance sheet effect of the losses. A banking crisis in the developed countries did not follow the launch of the Brady Initiative.

The debt management technique adopted by Secretary Baker and his official sector colleagues in 1982 therefore had the effect of grabbing the commercial bank creditors by their noses and holding them in place as the lenders of record until a more durable solution to the problem could be implemented. The concession made to the bank

13 See Lee C. Buchheit, Whatever Became of Old New Money, Int'l Fin. Law Review, December 1990.

lenders at the time was a restructuring technique that avoided accounting losses while the banks were provisioning their loan loss reserves. When the day of reckoning eventually arrived with Secretary Brady, the losses were felt by the bank creditors that had made the loans in the first place.

Contrast this to the debt management technique being used in Europe in 2010-2011. This time around, the official sector players are not holding the original lenders by the nose; the official sector is actually buying out the original lenders in full and on time as each existing bond matures and is paid by drawing down an official sector credit lines. The difference is this -- if the sword of a debt restructuring must eventually fall in order to render Greece's debt stock manageable (something that most economists view as inevitable), that sword will fall principally on the neck of the official sector lenders. The original creditors will have swapped places in the tumbrel with official lenders quite literally in the shadow of the guillotine.

8
Rules-Based Restructuring and the Eurozone Crisis

David A. Skeel, Jr.

For many who follow the sovereign debt markets, the current Eurozone crisis is "déjà vu all over again," only closer to home. After a series of sovereign debt crises climaxed with Argentina's default nearly a decade ago, many observers concluded that rescue funding—the traditional response to a crisis—was no longer a plausible response. Some found rescue funding problematic in principle, due to the moral hazard it creates. But the biggest concern was practical: after its many outlays, the IMF's funding was increasingly limited.

For a time, all options were (at least in theory) on the table. Most insisted that the traditional "ad hoc" machinery was adequate, perhaps as supplemented by the addition of "collective action" provisions in all new bond issuances. Others argued that it was time for a more comprehensive, rules-based, bankruptcy-like solution. In the end, the U.S. Treasury led a move toward more universal use of collective action in bonds, and more sweeping solutions were set to the side.

With the crises in Ireland, Greece and now Portugal, many of the same arguments have reappeared, but with a European flavor. Under the European Financial Stability Fund (EFSF), the default solution

in the Eurozone is rescue financing, but concerns about costs of rescues, their apparent ineffectiveness, and the moral hazard they invite has prompted serious calls for alternative approaches.

My remarks focus in particular on the question whether a comprehensive, rules based approach is plausible or desirable. The discussion that follows briefly considers:

1. The lessons of the Great Recession for the current crisis;
2. The contours of a sovereign bankruptcy framework;
3. Implications of distinctive EU features such as the Eurozone's federal structure and and common currency;
4. The linkages between sovereigns and major banks; and
5. The appropriate decision maker for a bankruptcy process.

A Lesson from the Great Recession

Thus far, European decision makers have taken something of a two-pronged approach to the crises that have enveloped Greece, Ireland and Portugal. The response to the immediate crises has been ad hoc bail out arrangements. But European officials have announced that they will require creditor haircuts as part of any bailout starting in 2013. The U.S. experience with systemically important financial institutions in 2008 suggests that it will be very difficult to make the commitment to forego future bailouts credible. After bailing out the investment bank Bear Stearns in March, 2008, U.S. Treasury Secretary Henry Paulson insisted that the government did not intend to bail out other banks. But the threat was not seen as credible by market participants. Up until a few days before Lehman Brothers filed for bankruptcy on September 15, 2008, Lehman, its potential buyers, and market participants all believed that Lehman would be bailed out. A similar dynamic may well be at work in Europe. Unless a credible, adequately-specified alternative to bailouts is put in place, the market will anticipate continued bailouts, and this will create enormous pressure for bailouts.

A Model for Sovereign Bankruptcy

The deepening crisis in Portugal suggests that bailouts, at least as configured thus far, may not stanch even the current crisis. Nor do collective action provisions seem to be adequate to the task. While there are legitimate questions as to whether a rules-based, bankruptcy framework is a realistic alternative, the limitations of the existing strategies suggest that it is time to revisit the question.

In earlier work, Patrick Bolton and I outlined a potential bankruptcy framework. In this section, I describe the core features of the framework, which includes clear priority rules, a two stage voting process, and a new financing mechanism.[1]

With respect to priority, the sovereign bankruptcy framework should include a straight first in time priority framework, together with voting procedures that call for absolute priority treatment– that is, the assurance that higher priority creditors will be paid in full, and that any haircut will be aimed first at lower priority creditors. Under our proposal, priority would be based on the time that the credit was extended, with the debt of any given year taking priority over debt issued in a subsequent year. Based on this priority, the sovereign debtor would divide its creditors into classes at the outset of a two tier voting process for restructuring the sovereign's debt. For the purposes of the first vote, the debtor would make a proposal as to how much of its overall debt would be discharged– that is, how large the overall haircut to creditors would be.

If a majority of all creditors approved the haircut, the debtor would submit a restructuring plan outlining the proposed treatment of each class of creditors for a second, class-by-class vote. If the requisite majority of each class voted yes, the plan would be implemented according to its terms. In the event that one or more classes rejected the plan, on the other hand, the court would reduce the creditors'

1 The discussion that follows is drawn from Patrick Bolton & David A. Skeel, Jr., Redesigning the International Lender of Last Resort, 6 CHI. J. INT'L L. 177, 189 (2005). This article extends an approach developed at greater length in Patrick Bolton & David A. Skeel, Jr., Inside the Black Box: How Should a Sovereign Bankruptcy Framework be Structured?, 53 EMORY L.J. 763 (2004).

claims in the amount of the agreed upon haircut, starting with the lowest priority creditors and working up the priority hierarchy.

This two step approach has several crucial virtues. Perhaps most importantly, it would clarify creditors' priorities outside of bankruptcy and sharply reduce the risk of debt dilution. The first in time priority scheme would apply outside of, as well as in, sovereign bankruptcy, because creditors would know that any subsequent bankruptcy would be governed by the first-in-time priority scheme. For sovereigns that actually invoked the procedure, the two step voting structure would provide a mechanism for pushing the parties towards a resolution even if bargaining breaks down, much as the threat of liquidation or cramdown do in ordinary corporate bankruptcies under U.S. Chapter 11.

The principal exception to absolute priority in our sovereign bankruptcy framework comes with its second key feature, interim financing. As with corporate debtors in Chapter 11, our framework would provide first priority for interim financing in order to counteract the debt overhang problem that otherwise might discourage lenders from financing the restructuring process. Because of the risk that priority treatment would encourage overborrowing, however, we distinguish between two categories of loans. Loans to finance the sovereign's trade debt would be presumptively permissible, whereas some form of approval, such as from a majority of the sovereign' s creditors would be required for larger loans. This strategy would effectively cabin the size of interim loans. In addition to minimizing the risk of overborrowing, it would also reduce the impact on the IMF's budget if it continued to serve as interim financer.

Is the Eurozone Different?

When this and other bankruptcy-oriented proposals were introduced in the early 2000s, critics objected that they would create moral hazard for debtors—making default too tempting—and that they would improperly interfere with the sovereignty of a financially distressed nation. How serious are these concerns in the Eurozone, and what other distinctive Eurozone factors need to be considered?

It is not clear whether debtor moral hazard would differ in Europe, as compared to Argentina and other developing world nations. Portugal, Greece, and Ireland depend heavily on financing from creditors within the Eurozone, which might discourage a precipitous bankruptcy filing (and seems to have been a key factor in Europe's decision to bail out Ireland). Whether or not this is the case, a sufficiently stringent bankruptcy process would limit the risk of unnecessary filings.

The sovereignty issue, on the other hand, cuts sharply in favor of bankruptcy. By entering the EU, these countries already have ceded a portion of their sovereignty to the larger EU structure. A bankruptcy framework would be much less intrusive in this context, where each country is already part of an interconnected framework.

Another distinctive feature, the common currency, also may counsel in favor of a sovereign bankruptcy framework. Because Greece, Ireland and Portugal have adopted the euro, they do not have the option of devaluing their currency in response to their crises. Bankruptcy would serve as a substitute for currency adjustments.

Implications for European Banks

Perhaps the biggest concern with bankruptcy—or any other restructuring of sovereign debt, for that matter—in the Eurozone is the potential effect on large European banks that hold large amounts of sovereign debt. Concerns about the possible damage to German and French banks in the event of an Irish default figured prominently in the decision to bail out Ireland. While the risk of contagion is a legitimate concern, it may make more sense for the countries in which the banks are located to make the decision whether to intervene in the event a sovereign bankruptcy destabilizes a foreign bank.

Who Would Oversee the Process?

Most previous sovereign bankruptcy proposals have proposed that the IMF or another international organization serve as the decision maker for the bankruptcy process. In our earlier work, Bolton and

I proposed that sovereign bankruptcy cases be handled by ordinary bankruptcy or insolvency judges. The debtor would be permitted to file in the courts of any nation (other than the debtor itself) whose law governed a nontrivial amount of the debtor's debt.

This approach may not be ideal for the Eurozone. This conclusion is informed in important respects by our experience in the recent crisis. Faced with bankruptcy filings in which the U.S. and Canadian governments had a vested interest with Chrysler and General Motors, U.S bankruptcy judges exhibited what appeared to be a disappointing lack of independence. This raises questions about the likely effectiveness of a single insolvency judge. One alternative, similar to proposals that have been made in other contexts, might be to select a panel of three judges from within EU to handle a bankruptcy case.

Conclusion

The intractability of the EU.crisis suggests the need to consider radical innovations such as bankruptcy. And the distinctive qualities of the EU framework suggest that the standard objections to sovereign bankruptcy are less relevant in the EU context.

9
The Economic Consequences of the Euro Pact

Edmond Alphandéry

In November 1919, Keynes published his famous book: "The economic consequences of the peace". Taking a challenging view on the issue of war reparations that were to be due by Germany, he argued that it was in the Allies' interest to be more accommodating. "If Germany is to be milked, she must not first of all be ruined",[1] he wrote, explaining that in order for Germany to pay, she had to be able to export enough goods in the first place.

At the present juncture of the Eurozone crisis, in the aftermath of the European Council of March 25, 2011 which has tried to design a "comprehensive" framework for permanent crisis prevention and resolution after June 2013, it is worth raising, as Keynes did after the first World War, the question of "sustainability". This notion is key because if one or two (even more) countries were at that time posting budget deficits which make their public finance unsustainable, then according to the conclusions of the European Council, they could be required to engage into negotiations with their creditors on the terms of their contracts, which might jeopardize the financial sector of the Eurozone.

1 Cited by Liaquat A. Hamamed, Lords of Finance, Penguin book, 2009, page 109.

In order to explore the various scenarios ahead, as the title of this panel[2] suggests we are invited to look at past experiences (like Argentina which had to abandon its currency board in 2001 or the demise in August 1971 of the Gold Exchange Standard). The starting point is therefore the assumption that the Eurozone is an area of "fixed exchange rates" between its Member States. Should a country leave the Eurozone and go back to its own national currency, it would then recover its own monetary sovereignty and could manipulate its exchange rate to regain competitiveness, etc.

This assumption neglects the fundamental fact that the Eurozone cannot be considered as a "fixed exchange rate" area for the sheer reason that national currencies have disappeared (we don't have exchange rates any more). It underestimates the political dimension of EMU. The likelihood that this scenario comes true is therefore as high as to see Texas or California abandon the dollar for a new currency!

One cannot put on the same footing a Country which may decide to forego the peg of its currency as it is free of its movements to do so, with a State like Greece or California which are part of a bigger political entity and share the same currency with their neighbours, and have therefore to abide by a set of common rules and constraints. Should a government want to get rid of the euro, it would soon realize that besides the enormous damages to its financial stance and to its economy that such a decision would entail, it would have to put in place capital controls and coercive measures to force its people to use the new "national currency" in lieu and place of the euro. It would therefore in fact be faced with the prospect of leaving the European Union, an occurrence of devastating consequences for the country, notwithstanding the risk for its democratic institutions. It is no surprise that this outcome is only contemplated by extreme right political parties like the "Front National" in France, which are not sparing of demagogical and irresponsible proposals.

Now another scenario which may not be totally ruled out even though its likelihood remains extremely small, draws on the blow out

2 "Alternatives to sovereign bankruptcy?"

of the Eurozone and on the breakdown of the euro. Many eurosceptic economists fantasise on this outcome, arguing that the Eurozone is not an "optimum currency area", that it has built-in asymmetries which may entail corrections that are too painful to be implemented, etc. The burst of the euro (or the split of the Eurozone into two parts) which could happen only with the explosion of the European Union itself, would trigger a systemic shock worldwide of much wider amplitude than the collapse of Lehman Brothers itself, and would probably lead to enormous political tensions in Europe. For these reasons, we can remain confident that everything will be undertaken at any price to prevent this apocalyptic scenario to materalize. Besides, it is interesting to observe that market participants seem more and more convinced of the lack of credibility of this assumption, as is reflected in the decorrelation between the evolution of the euro exchange rate (which has steadily appreciated over the last months), and the evolving situation in the Eurozone where solvency issues in some Member States still remain a matter of major concern.

The question which we therefore should better raise has to do with "sustainability": should a Member State (or more) risk to fail, what devices should be put in place to ease its debts, walk the nation back through a path of sustainability and make easier its access and return to financial markets?

Due to the idiosyncratic dimension of our European institutions, one cannot draw on sovereign default prevention and resolution from other countries in the past or abroad when one has to deal with the case of a Eurozone Member which would be unable to face its financial obligations.

What characterizes the Eurozone is precisely the bonds of solidarity interwoven by the member states over the years, through the construction of a European community. The establishment of the various devices and institutions that have been put in place to cope with the crisis that the Eurozone has been suffering for the past 18 months, is based on the dynamics between the ethic of responsibility called upon each nation taken individually and the principle of solidarity that underpins the European construction, which applies all

the more to Members of the Eurozone.

When a crisis looms on the horizon, both the above forces are at work. It is left at first hand to each state to render its own house in order. As Axel Weber writes: *"Responsibility of individual member countries and no bail out remain essential for the EU… It is up to the Member countries themselves to consolidate their public budget and to initiate comprehensive economic reforms"*.[3] But if and when the risk of failure threatens not only the financial stability of the economy of the country in trouble, but also the financial stability of the European Union as a whole, then the principle of solidarity ends up prevailing.

In this paper, we shall formalize the working of this dynamic process. Thanks to this analytical tool we shall explain the evolving interventions of the European authorities since the beginning of the crisis; and then make use of this framework to figure out the potential outcomes after June 2013. This paper will lastly conclude on the probable complementary decisions that should be taken to reduce the risk of crisis that we may incur from this date.

1) The dynamics of the response of the European Union to the Eurozone crisis

When the European states signed the Maastricht Treaty, they had not foreseen any provisions to deal with a later possible crisis in the euro area. When faced with it, then they had to grope their own way to design the assumed proper devices under the market pressure.

The logic behind their implementation ultimately obeys a rational argument, that of an ex-ante cost-benefit analysis. There is an expected potential cost for the European Union not to intervene. It is made of the sum of the bankruptcy damages for the banking and financial sector and the economy of the Eurozone as a whole and of the harm suffered by the European Union in terms of its image since it would have left one (or several) of its members when in crisis fall without a helping hand. The perception of this cost rises as we approach the

3 Axel Weber, "Europe's reforms may come at a high price", Financial Times, February 22, 2011.

expected time of bankruptcy (Figure 1).

On the other hand there are also beneficiary reasons not to intervene. Firstly helping a member will dent the incentive for the given country (and for others) to undertake the necessary reforms ("the moral hazard" issue). This "benefit" of non intervention is also increasing with the supposed vicinity of the expected bankruptcy; it corresponds for the European Members involved to the expected savings of funds, which they would not need to mobilise.

If on the same graph we draw the curve of these "expected" costs and "expected" benefits, as long as the crisis is considered far away enough, the benefits of non intervention outweigh the costs. However as perception of the crisis grows, the vertical distance between the two curves goes down to the point where they intersect; and the European authorities are ready to act. Rationally this intention must come before the country's failing; hence the vertical line representing the expected cost of bankruptcy is situated to the right of the intersection. One can say that the horizontal distance between the expected moment of intervention and the expected bankruptcy curve is an indication of stress, and therefore of the spreads of the Government bonds.

In 1977, Jean Monnet wrote in his memoirs, presciently: « L'Europe se construira à travers les crises et elle sera la somme des solutions apportées à ces crises » ("Europe will be forged in the crucible of crisis, and will be the sum of the solutions that finds to crisis"). Lorenzo Bini Smaghi, a member of the Executive Board of the European Central Bank, says the same thing when he writes: *"Europe is evolving, growing, continuously on its path of integration. This is not happening, however, according to some predefined, agreed plan, but rather in response to the challenges it faces, which in some cases are likely to endanger the very existence of the Union".*[4]

4 Cited by Martin Wolf, "The grand bargain is just a start", Financial Times, March 30, 2011.

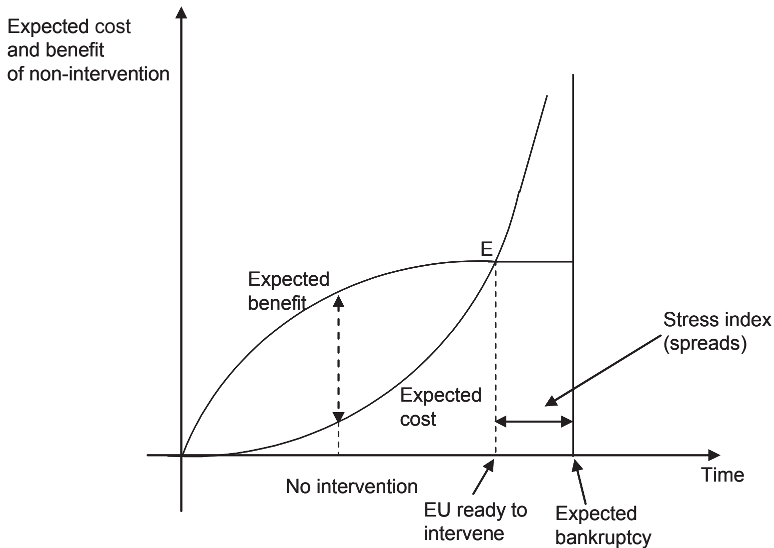


Figure 1

The use of the above analytical tool explains well enough the roadmap of European institutions since the start of the crisis, which has led to the gradual establishment of the new arrangements in a Monnet like approach.

Since the beginning of the crisis, the European authorities have intervened on four occasions.

In May 2010, they have set up an assistance programme for Greece in the form of loans (ESFM) that was extended to all member countries with public finances in distress by establishing the European Financial Stability Facility (EFSF).

Secondly, bail out to the Irish banks came indirectly through aid to the Irish Government. Well in advance the European authorities had adopted the principle of a "permanent European mechanism" for crisis resolution (the ESM) to be applied from June 2013. They also announced that issuance of the sovereign debts after June 2013 would bear Collective Actions Clauses (CAC), a decision which could be viewed as a means to mitigate moral hazard. This latter

signal was negatively interpreted by the markets. Market participants raised their expectations on the likelihood of a bankruptcy. It is not surprising therefore that interest rate spreads widened.

A reverse dynamic played out in March 2011 after the European Council adopted the Euro Pact, because in parallel the European authorities decided that the loans extended to Greece (and possibly later to other countries) under the European Stability Mechanism, will benefit from significantly lower rates (4.2%), and were also rescheduled to 2021.

The third bail out was decided for Portugal on April 6th. But the European authorities had already announced long in advance that they were ready to provide assistance to Portugal, which it reluctantly ended up calling.

2) The implementation of the European Stability Mechanism in June 2013

Let us explore now the consequences of the introduction of the European Stability Mechanism. As from June 2013, the ESM will have a funding capacity of € 500 billion (supplemented by funds from the IMF) in order to provide help to a Eurozone Member under strict conditionalities, through loans or purchases of public bonds on the primary market. The rules under which this assistance will be extended are fully described in the conclusion of the European Council of March 24-25, 2011.

If after a thorough analysis of the debt sustainability of the Member State requesting financial support, *"it is concluded that a macroeconomic adjustment program can realistically restore the debt to a sustainable path, the beneficiary Member State will take initiative aimed at encouraging the private investors to maintain their exposures"*, and this Member State will be entitled to receive assistance from the ESM at a preferred interest rate. But *"if, on the basis of a sustainability analysis, it is concluded that a macroeconomic program cannot realistically restore the public debt to a sustainable path, the beneficiary Member State will be required to engage in active negotiations in good faith with its credi-*

tors to secure their direct involvement in restoring debt sustainability. The granting of the financial assistance will be contingent on the Member State having a credible plan and demonstrating sufficient commitment to ensure adequate and proportionate private sector involvement".[5]

The assumption that after June 2013 the EU could let one (or more) Member(s) to fail lacks credibility. Solidarity has already been put to test three times: when the Eurozone prevented the downfall of Greece, then of Ireland and lastly of Portugal. It is highly unlikely the European authorities will take the risk of a bankruptcy in June 2013 that could trigger a systemic crisis, and also will leave a country in a state of insolvency after years of painful economic and social sacrifies.

In the most likely scenario, the ESM will take over a big chunk of the public debt of each of the countries which will have applied to the ESM, as the EFSF and the private sector loans coming to redemption are replaced by new issuances of the same amount.[6]

3) Alleviating the pressure on the June 2013 "rendez-vous"

It would be better if the European authorities could avoid being faced with any of the two following options in June 2013. Either they conclude that the country (Greece, Ireland or Portugal) is on an unsustainable path and therefore cannot qualify for assistance under the ESM, and they let it default, or they consider that it is capable of stabilising its debt and allow it to receive ESM loans subject to strict conditionality. In the latter case, it would probably be very difficult to subsequently withdraw ESM support, with the result that the country's debt would gradually be assumed by the European Union itself.

The best situation would clearly be by the end of 2013 that none of these scenarios materializes and that each of these countries be in a position to refinance its debt directly on the financial markets. The

5 Conclusions of the European Council, March 24-25, 2011

6 It is precisely to try to avoid the ESM taking over the whole public debts of these countries that in the conclusions of the European Council of March 24-25, there is an incitement to "beneficiary members [to] take initiatives aimed at encouraging the main private investors to maintain their exposures".

ESM is not designed to take on the debt of countries in difficulty.[7]It is a fund set up to safeguard the financial stability of the euro area as a whole at a given point in time.

Let's look at how the sustainability issue applies to each of these three countries whether they obtain financing in the future through the ESM or on the financial markets. We performed simulations based on International Monetary Fund inflation and economic growth forecasts. For the purpose of these simulations, we considered that the three countries would have complied with the economic adjustment programmes imposed under their agreements with the IMF and the European Union.[8] We also assumed that each country's annual refinancing needs would remain constant over the simulation period. We're going to examine the sustainability of their public debt, that is whether public debt as a percentage of GDP is likely to stabilize and then decline. This means looking at the stabilizing deficit (as a % of GDP) which can be defined as the level of budget deficit at which the debt (as % of GDP) stabilizes. By comparing the actual deficit (as a % of GDP) with the stabilizing deficit, we can see whether the country is or is not on a debt sustainability path.[9]

7 These forecasts stop at 2015, and we have extrapolated the numbers from 2015 to 2016 and 2017. These tables have been produced by Sophie Chardon and the Economic Research Team of Natixis under the Direction of P. Artus (of course, I alone assume full responsibility for the content of this paper). I would like to thank them for their help.

8 For instance, a country whose average maturity of traded debt is 7 years is considered as having refinanced 5/7th of its total debt in 2016, at a rate of 1/7th per year starting in 2012.

9 Hence, the public debts dynamic can be written as:

$$D_t = D_{t-1} + d_t - \underbrace{\frac{g_t}{1+g_t} D_{t-1}}_{StabilizingDeficit}$$

with: D_t being the ratio of debt to GDP at time t

d_t being the ratio of deficit to GDP at time t

g_t being the growth rate of GDP at time t

TRAJECTORIES OF DEFICITS AND DEBTS IN GREECE, PORTUGAL AND IRELAND

Scenario 1: Borrowing via ESM

Greece = 4.2%

Ireland and Portugal = AAA RATE + 200pb the first three years, + 300pb thereafter

GREECE

	GDP Deflator	GDP growth (real)	Interest rates (%)	Interest burden (as % of GDP)	Total Deficit (as % of GDP)	Stabilizing Deficit (as % of GDP)	Public Debt evolution (as % of GDP)
2011	1.6	-3.0	4.2	-6.5	-8.6	2.0	151
2012	0.4	1.1	4.2	-6.7	-7.7	-2.2	156
2013	0.8	2.1	4.2	-6.8	-6.2	-4.4	158
2014	1.2	2.1	4.2	-6.8	-4.1	-5.0	157
2015	0.6	2.7	4.2	-6.7	-3.3	-4.9	156
2016	0.6	2.7	4.2	-6.5	-2.5	-4.9	153
2017	0.6	2.7	4.2	-6.4	-1.7	-4.8	150

Sources: National Statistics Service, Bank of Greece, Ministry of Economy and Finance, IMF, Natixis

PORTUGAL

	GDP Deflator	GDP (real)	Interest rates (%)	Interest burden (as % of GDP)	Total Deficit (as % of GDP)	Stabilizing Deficit (as % of GDP)	Public Debt evolution (as % of GDP)
2011	1.4	-0.9	7.0	-3.8	-5.3	-0.4	88
2012	2.7	0.3	5.8	-4.1	-4.2	-2.5	89
2013	2.1	0.7	5.8	-4.3	-3.5	-2.4	90
2014	2.1	1.3	5.8	-4.3	-2.9	-2.9	90
2015	2.1	1.3	6.9	-4.5	-2.4	-2.8	90
2016	2.1	1.3	7.0	-4.6	-1.9	-2.8	89
2017	2.1	1.3	8.0	-4.7	-1.4	-2.7	88

Sources: National Statistics Service,Ministry of Economy and Finance, IMF, Natixis

IRELAND

	GDP Deflator	GDP (real)	Interest rates (%)	Interest burden (as % of GDP)	Total Deficit (as % of GDP)	Stabilizing Deficit (as % of GDP)	Public Debt evolution (as % of GDP)
2011	0.4	0.9	5.8	-4.2	-12.4	-1.3	109
2012	0.8	1.9	5.8	-5.0	-10.6	-2.8	116
2013	1.4	2.4	5.8	-5.5	-8.9	-4.1	121
2014	1.6	3.0	5.8	-5.7	-6.7	-5.1	123
2015	1.6	3.4	6.9	-5.9	-6.2	-5.5	124
2016	1.6	3.4	7.0	-6.1	-5.7	-5.4	124
2017	1.6	3.4	8.0	-6.2	-5.1	-5.2	124

Sources: CSO, Department of Finances, IMF, Natixis

Scenario 2: BORROWING ON THE MARKETS AFTER 2013 AT 10%

GREECE

	GDP Deflator	GDP (real)	Interest rates (%)	Interest burden (as % of GDP)	Total Deficit (as % of GDP)	Stabilizing Deficit (as % of GDP)	Public Debt evolution (as % of GDP)
2011	1.6	-3.0	4.2	-6.5	-8.6	2.0	151
2012	0.4	1.1	4.2	-6.7	-7.7	-2.2	156
2013	0.8	2.1	5.6	-7.2	-6.5	-4.4	158
2014	1.2	2.1	10	-8.5	-5.7	-5.0	159
2015	0.6	2.7	10	-9.3	-6.0	-4.9	160
2016	0.6	2.7	10	-10.0	-5.9	-4.9	161
2017	0.6	2.7	10	-10.4	-5.7	-4.8	162

Sources: National Statistics Service, Bank of Greece, Ministry of Economy and Finance, IMF, Natixis

PORTUGAL

	GDP Deflator	GDP (real)	Interest rates (%)	Interest burden (as % of GDP)	Total Deficit (as % of GDP)	Stabilizing Deficit (as % of GDP)	Public Debt evolution (as % of GDP)
2011	1.4	-0.9	7.0	-3.8	-5.3	-0.4	87.7
2012	2.7	0.3	5.8	-4.1	-4.2	-2.5	89.3
2013	2.1	0.7	5.8	-4.3	-3.5	-2.4	90.4
2014	2.1	1.3	5.8	-4.3	-2.9	-2.9	90.5
2015	2.1	1.3	10	-4.8	-2.8	-2.8	90.5
2016	2.1	1.3	10	-5.2	-2.5	-2.8	90.2
2017	2.1	1.3	10	-5.4	-2.1	-2.7	89.6

Sources: National Statistics Service,Ministry of Economy and Finance, IMF, Natixis

IRELAND

	GDP Deflator	GDP (real)	Interest rates (%)	Interest burden (as % of GDP)	Total Deficit (as % of GDP)	Stabilizing Deficit (as % of GDP)	Public Debt evolution (as % of GDP)
2011	0.4	0.9	5.8	-4.2	-12.4	-1.3	109
2012	0.8	1.9	5.8	-5.0	-10.6	-2.8	116
2013	1.4	2.4	5.8	-5.5	-8.9	-4.1	121
2014	1.6	3.0	5.8	-5.7	-6.7	-5.1	123
2015	1.6	3.4	10	-6.4	-6.7	-5.5	124
2016	1.6	3.4	10	-6.9	-6.5	-5.4	125
2017	1.6	3.4	10	-7.2	-6.1	-5.2	126

Sources: CSO, Department of Finances, IMF, Natixis

When they obtain financing through the ESM,[10] we can see that all three countries will succeed in stabilizing their debt by 2017, with Greece making the fastest progress, followed by Portugal, and with Ireland bringing up the rear.

On the other hand, if they have to borrow on the financial markets as from 2013[11] at an interest rate of say 10%, none of them will manage to stabilize their debt (because their total deficit will exceed their stabilizing deficit). However, they will all come very close to meeting this target by the end of the simulation period.

In other words, for them to be able to meet their financing needs directly on the market, their debt burden would just have to be marginally reduced. This has to be the goal. It's why the best course of action would be for each country to reduce its public debt as quickly as possible. For example, they could be encouraged to launch a large-scale privatization programme, as Greece is already being urged to do. Or the terms of European Union loans could be further improved by aligning them with those offered by the International Monetary Fund.

10 At a rate of 4.2 % for Greece assumed to be applied starting 2013 and for Ireland and Portugal at the AAA European Union public debt rate to which is added 200 bps for the first 3 years and then 300 bps afterwards.

11 Until 2013, we assumed that Ireland benefits from IMF, EFSM and ESFS loans of € 22.5 bn each at an average interest rate of 5.8%, the EFSM lending at 5.7%, the EFSF at 6.05% and the IMF at 5.7%. For Ireland, we take an interest rate of 5.8% for a global amount of € 75 bn until June 2013.

10
Exiting the Euro Crisis

Charles W. Calomiris

I. Introduction

What do economics and history have to tell us about the ways Eurozone countries are likely to resolve their problems of fiscal unsustainability and banking system insolvency? In answering that question, I recognize that I am among the most pessimistic observers at this conference about the likely future of the euro and its membership. My relative pessimism reflects three personal attributes.

Arithmetic Trumps Legalism

First, I am an economist, which means that I place more stock in arithmetic than in the legalities of what countries supposedly are or are not permitted to do; legislation or politicians' pronouncements about the impossibility of a departure from the Eurozone count for little if arithmetic requires it. I will argue that in the case of at least one country – Greece – the fiscal arithmetic strongly favors not only a sovereign debt restructuring but also a departure from the Eurozone, and there may be others for whom this same outcome will soon become a necessity as well.

Real Exchange Rate Theory and Political Economy

Second, I am an American. Since before the establishment of the euro, American economists have had a distinctly more pessimistic view of the euro experiment than have their European colleagues. Two years ago, Lars Jonung and Eoin Drea published a detailed and quite humorous review of the difference in opinion about the euro between American and European economists. Its title characterized what it (then) regarded as the excessive pessimism of the Americans: "The Euro: It Can't Happen, It's a Bad Idea, It Won't Last. U.S. Economists on the EMU, 1989-2002."[1] In fact, my own 1999 paper predicting the eventual collapse of the euro was included in that review. The implicit theory behind the Jonung and Drea paper was that American economists (perhaps out of jealousy or nationalism) did not want to believe that the euro would work. In light of recent events, an alternative theory may have greater weight: Europeans were in denial. After all, wishful thinking (the result of a need to resolve "cognitive dissonance") is a fairly pervasive aspect of human nature.

In 1999, and subsequently, I predicted that roughly a decade after its creation, either some members of the Eurozone would be forced to leave, or the currency would depreciate dramatically as a means of keeping those countries in the Eurozone.[2] In particular, I predicted that southern European countries would become fiscally unsustainable, and that losses of European banks would create significant bank insolvencies, which would put further fiscal pressure on governments through the costs of bank bailouts.

No, I am not a modern-day Nostredamus. I was not alone in those prognostications, and the economists that predicted the outcome that Europe is now suffering did not rely on any supernatural access to insights. The consequences of the euro's launch were predictable for the simple reason that the Eurozone was not an "optimal cur-

1 European Economy Economic Papers, No. 395, Economic and Financial Affairs, Directorate General, European Commission, December 2009.

2 Charles W. Calomiris, "The Impending Collapse of the European Monetary Union," Cato Journal, Winter 1999, pp. 445-52; "The Painful Arithmetic of Greek Debt Default, March 18, 2010, Economics21.org; "The Euro Is Dead," Foreign Policy, January 6, 2011.

rency area." Its demise was a likely result of the deadly combination of fundamental economic inconsistencies among its members and the predictably myopic political palliatives that would be applied by individual members to ease the pain caused by those fundamental inconsistencies. Here is the train of thought that I thought was pretty obvious in 1999.

Southern Europe (especially Greece, Portugal, and Southern Italy) has low long-term productivity growth, particularly in tradable goods. This relative productivity growth gap was likely to persist as the result of a combination of pre-existing trade patterns, human capital differences, rigid labor laws in the South, and low labor mobility in Europe. As we learned from the experience of the East Asian fixed exchange rate collapses of 1997, and from the Harrod-Balassa-Samuelson theory of real exchange rate determination (as embodied in many macroeconomic models, including the rational expectations models of real exchange rates pioneered by Rudiger Dornbusch in the 1970s), if two countries with persistent productivity growth differences in their tradable goods sectors adopt a common currency, eventually the slow-productivity growth country will experience recessionary pressure, and eventually, it will either have to suffer continuing price deflation or devalue its currency.

As Alwyn Young pointed out, East Asian countries' relative productivity decline began several years prior to the crisis of 1997, and as Campbell Harvey and Andrew Roper point out, the financial leveraging of East Asia was a direct response to the lost profitability of manufacturers, who were able to obtain explicitly or implicitly subsidized access to credit to fill the gap between their income and their expenditures. The result, however, was growing leverage and increasingly unsustainable private sector and bank finances.[3]

Of course, in the short run, countries do not have to accept the dismal choice between slow growth and devaluation. Instead, they can apply fiscal stimulus, or facilitate (through easy bank credit) the

3 Alwyn Young, "The Tyranny of Numbers: Confronting the Statistical Realities of the East Asian Growth Experience," Quarterly Journal of Economics, 110 (3), pp. 641-80; Andrew H. Roper and Campbell R. Harvey, "The Asian Bet," Social Science Research Network, March 18, 1999.

growth of the non-tradables sector (also known as housing). Even worse, that temptation to compensate with fiscal stimulus and easy credit will be greater if the establishment of the currency union itself lowers the interest rates on sovereign debt or bank debt that the low-tradables-productivity-growth countries face. That was an important contributor to the fiscal binge of Greece, which ran fiscal deficits in excess of 5% of GDP in its boom years of 2004-2006. It should not be a surprise that Greece, Portugal, Italy, Spain and Ireland all underwent (albeit in different degrees) significant fiscal spending and bank lending booms, and that some of them saw remarkable rates of appreciation in housing markets. This is precisely what one would expect from the long-run implications of real exchange rate theory and the short-run implications of political economy theory.

"Why, Sometimes I've Believed as Many as Six Impossible Things Before Breakfast."[4]

Third, I am an historian, and so I know that erstwhile impossible things – from a legalistic perspective – happen regularly in financial and monetary history. For example, consider the U.S. departure from the gold standard at the beginning of 1862, which began a seventeen-year period of U.S. experience known as the period of suspension under the "greenback" standard. Prior to the creation of legal tender notes by the Federal government and the suspension of gold convertibility in 1862, the U.S. government had never issued legal tender notes, nor was there any credible basis for the view that the government had the Constitutional authority to do so.

The government had issued some Treasury bills during the War of 1812, for a brief time, and had made them receivable for payments of taxes, but it promptly withdrew those notes after the War ended, and never declared them a legal tender for private debts. That experience comported well with the consensus that had emerged from the founders' Constitutional debates over the monetary powers of the U.S. government during the Constitutional convention. Under the Constitution, the Federal government was not given the right to declare anything but gold and silver a legal tender, but neither was it strictly forbidden from doing so (in contrast, the individual

4 Lewis Carroll, Through the Looking Glass.

states were forbidden). Delegates avoided the strict prohibition on the argument that it might be expedient as a temporary war measure to permit the federal government to issue paper legal tender, but there was also a consensus against allowing a permanent role for government-supplied legal tender.

Very few people would have argued, say, in 1860, that the federal government was likely to assert the right to create legal tender paper money as a permanent component of the money supply, or to substitute it for gold and silver as the definition of the dollar. But then the Civil War happened. Within a few months of the outbreak of the War – which was initially regarded as an event likely to cost the North little, and to last for only a few months – it became clear that the War would, in fact, cost much more, and take much longer, than anyone had guessed. In the fall of 1861, the initial debt offerings by the government had not gone well, and the government enlisted the banks of New York, Boston, and Philadelphia to subscribe to the debt as a syndicate. Within a few weeks of stuffing the banks full of new government debt, however, the Secretary of the Treasury, Salmon Chase, released a report estimating substantial increases in war expenditures, and proposing not to increase taxes to help finance the war. The result was a collapse of the value of government debt, which prompted a suspension of convertibility by the banking system (whose assets had consequently suffered major losses).

The legal tender law of 1862 was, effectively, a bank bailout. By creating a new, depreciated numeraire (the greenback), and by allowing dollar claims (including deposits) to be denominated in this depreciated version of the dollar, rather than in gold or silver, the government offset the negative shock to bank assets from government bond depreciation with a similar negative shock to the value of deposits. Later the legal basis for legal tender notes was challenged, but since it had been employed during wartime as an expedient to ensure the survival of the government and the banks, and since it would have been very difficult to unwind the sequence of payments that had been made on a depreciated currency basis over several years, its Constitutionality was upheld. To ensure that it was upheld, President Grant added two Justices to the Supreme Court (another outcome

that many would have dismissed as far-fetched in 1860). The force majeure of fiscal necessity can be a source of great legal innovation.

Nor was this U.S. experience exceptional. In 1933, the U.S. government prohibited the enforcement of gold clauses in private debt contracts. It did so to assist debtors to survive the double blow of a weak economy and a depreciated dollar (which increased the burden of paying gold-denominated debt). In a five-to-four Supreme Court decision, that action was upheld in 1935.That Supreme Court decision was widely regarded as permitting the government to orchestrate illegal takings from creditors and was decried as such in an apocalyptic minority dissent.

As recently as 2002, the Argentine Republic put aside its Constitutionally mandated adherence to a dollar-linked currency board when it left the dollar standard and redenominated dollar-denominated and dollar-indexed contracts into the newly depreciated peso. The precipitating event that led the Argentine government to recognize the need to resolve its longstanding fiscal crisis – which had been going on for over two years – was the run on Argentine banks that occurred in December 2001, which precipitated a suspension of convertibility of deposits.

II. The Divergent Realities of the Eurozone

I will not repeat here in detail my prior analyses published elsewhere of the currently unsustainable paths of Greece, Portugal, Ireland, Italy, and (depending on its bank bailout policies) Spain, but I would emphasize that these countries are not all facing the same problems, and that their strategies for dealing with their problems should differ, as should the strategies of the EU for agreeing loss-sharing arrangements to address those problems.

There are three distinct problems related to Eurozone membership that confront this group of countries: (1) over-indebtedness, (2) high deficits in combination with over-indebtedness, and (3) non-competitiveness. These problems are distinct and pose different challenges for policy, and the relative weights to attach to these three

problems differ across the Eurozone countries that are currently under the greatest pressure.

First, debt sustainability refers to an excessive amount of debt relative to GDP, which must be addressed through some form of default and restructuring.

Second, high deficits add another dimension to that problem. A country that defaults on its debt will find it difficult to fund its continuing deficits through new issues of sovereign debt into the market. Thus, a high-deficit country that is also in need of restructuring either must leave the Eurozone to print money to finance its continuing deficits, or obtain public-sector support for deficit borrowing "in arrears" in the wake of its default (presumably with the hope of quickly ending its deficits, so that public sector support does not result in a second debt default).

Third, countries with over-valued exchange rates (which resulted from their slow productivity growth in tradable goods and their rigid labor markets) face the difficult choice between a protracted period of recession as their wages and prices decline to restore competitiveness, or departing from the Eurozone, depreciating their currency, re-denominating their wages, prices, and bank deposits in the newly depreciated currency, and immediately beginning their recovery. Under either of those scenarios, long-term reforms of labor markets and other policies to address competitiveness are desirable, but those long-term reforms will not resolve the short-term problem; in the short term, over-valuation implies a clear tradeoff between continuing recession and devaluation.

In my view, all three of the fundamental problems listed above are severe for Greece. It is a matter of simple arithmetic that Greece's debt is not sustainable. Greece's deficits are also large, and it would be challenging for it to succeed in credibly promising to shrink those deficits to obtain sufficient short-term financing in arrears to avoid leaving the Eurozone as it restructures its debts. Even if financing in arrears were possible, the costs of continuing over-valuation would deepen Greece's recession because of over-valuation. It is hard to see

how – absent a massive transfer (not a loan) to Greece of roughly two hundred billion euros – Greece can avoid both debt default and exiting the Eurozone. Portugal's situation is not as dire, but similar logic applies to its case. A restructuring and an exit from the euro would seem to make sense as a means of resolving all three problems.

Countries that leave the euro could and should re-join it in a matter of a few years, after undertaking significant reforms to their fiscal affairs, labor markets, and pension systems. It makes no sense to prohibit them from re-joining, and that prospect could be a useful source of encouragement for reforms.

Ireland and Spain are in a somewhat different position than Greece and Portugal. If they can avoid domestic government assumption of their local banks' debts held abroad (e.g., by German, UK, Belgian, and Danish banks), then they are not clearly in unsustainable fiscal positions (although Ireland's absorption of bank debt already has placed it at substantial risk in that regard). And there is a more realistic possibility of improvement in Spain's and Ireland's competitiveness positions and economic performance, if they can avoid the debt sustainability trap that would result from absorbing their banks' debt problems. If instead they absorb their failed banks' debts, they will make their sovereign debt problems much worse, and probably unsustainable. Although the right policy choice is clear, Ireland and Spain have come under enormous pressure from European counterparts (and from domestic political friends of insolvent cajas in the case of Spain) to absorb those debts. They must find the political will to say no.

Italy's situation is also unique. Its debt sustainability problem could be solved with quick, significant, but not crippling, cuts in fiscal expenditures, combined with significant reforms in tax collection and corruption. But Italy is deeply broken politically. There seems to be little prospect for timely and necessary policy changes to be implemented.

III. What Should Happen vs. What Will Happen

The best path forward for the Eurozone would be to encourage the policy adjustments for Greece, Portugal, Ireland, Spain, and Italy discussed above, and to agree loss-sharing arrangements to absorb in an orderly way the losses that would result to German, UK, French, Belgian, Danish, and other countries' banks from sovereign defaults and failed Irish and Spanish banks' and cajas' defaults.

If history is a guide, however, this is not the way the euro crisis will be resolved. Governments likely will prefer to try to postpone taking unpopular measures, and thus will not resolve the problems at hand. The most likely outcome will be a chaotic sequence of ad hoc and poorly coordinated emergency measures, taken in response to bank runs that will begin in Greece or somewhere else as depositors become increasingly wary of continuing euro convertibility of their deposits. The time to act is now, as the possibility of undertaking an orderly and sensible resolution of the crisis is slipping away.

11
Life With and Without Sovereign Defaults: Some Historical Reflections

Youssef Cassis

The lines which follow are a few reflections destined to put the discussion on sovereign defaults in a historical perspective. Three points will be considered.

The first concerns the challenge presented to historians by the financial debacle of 2007-2008 and the ensuing economic and financial turbulence. In some respects, historians were very well prepared to meet this challenge, in some others less so. The reason is that while the history of financial crises has attracted renewed interest since the late 1980s, the issues raised by the recent events had only been partially addressed by the ongoing research.

Interest in the history of financial crises really took off, after the International Debt Crisis of 1982 (Eichengreen and Lindert, 1989).[1] Unlike previous work, most notably Charles Kindleberger's Manias, Panics and Crashes (Kindleberger, 1978),[2] which primarily dealt

1 Eichengreen, Barry and Peter Lindert, eds. (1989). The International Debt Crisis in Historical Perspective, Cambridge, Mass., MIT Press.
2 Kindleberger, Charles (1978). Manias, Panics and Crashes. A History of Financial Crisis, London, Macmillan.

with advanced economies, the comparative history of financial crises has, since then, almost exclusively been concerned with emerging economies. This is not surprising given that, with the exception of the interwar years, most financial crises since the late nineteenth century have taken place in developing countries (Bordo et al., 2001).[3] Attention has focused on various types of financial crises –banking, currency, and twin crises, as well as, increasingly, sovereign defaults; on the role of monetary regimes, especially the gold standard, and of capital flows; on the consequences of financial crises on the real economy, including conditions of recovery (Bordo and Rogoff, 1996; Goodhart and Delargy, 1998; Flandreau and Zumer, 2004; Ferguson and Schularik, 2006).[4]

At about the same time: historical analyses of financial crises became far more econometric in their approach, relying on vast databases and attempting to empirically test theoretical hypothesis. They have also adopted a 'now and then' approach, keen to draw policy lessons from past historical experiences (Mauro, Sussman and Yafeh, 2006),[5] and have been carried out by economists or economic historians coming from the economics rather than the history side of the profession. As a result, we have a clearer typology of financial crises; we have far more data on their frequency, their length and depth, their interactions with recessions, the effects of policy responses; we know more about their relationships with exchange rate regimes and international capital flows. The causes and unfolding of financial crises are also better documented. The drawback is that quantitative

3 Bordo, Michael, Barry Eichengreen, Daniela Klingebiel, Maria Soledad Martinez-Peria, Andrew K. Rose (2001). 'Financial Crises: lessons from the last 120 years', Economic Policy, 16, 32.

4 Bordo, Michael D. and Hugh Rockoff (1996). 'The Gold Standard as a 'Good Housekeeping Seal of Approval'', Journal of Economic History, 56, 2.;
Goodhart, Charles and P.J.R. Delargy (1998). 'Financial Crises: Plus ça Change, plus c'est la Même Chose', International Finance, 1, 2.;
Flandreau, Marc and Dominique Zumer (2004). The Making of Global Finance 1880-1913, Paris, OECD.;
Ferguson, Niall and Moritz Schularik (2006). 'The Empire Effect: The Determinants of Country Risk in the First Age of Globalization, 1880 1913', Journal of Economic History, 66, 2.

5 Mauro, Paolo Nathan Sussman and Yishay Yafeh (2006). Emerging markets and financial globalization: sovereign bond spreads in 1870-1913 and today, Oxford, Oxford University Press.

analyses lump rather than split, emphasize the common points rather than the differences and, by their very nature, cannot take into account micro-mechanisms.

However, this time is different, to paraphrase Reinhart and Rogoff, whose recent book is the culmination of empirical studies on financial crises (Reinhart and Rogoff, 2009).[6] The financial debacle of 2007-2008 was the most serious financial crisis in history; and it was a banking crisis taking place in advanced economies –a fairly rare occurrence since the 1930s. Crises erupting in emerging economies present a different reality –at economic, social and political levels. The same applies, though possibly to a lesser extent, to the sovereign debt crises in the Eurozone. On the one hand it is reminiscent of 19th century defaults by peripheral European countries, and the historical literature has paid much attention to sovereign debt crises. But on the other hand the European monetary union is a unique historical experience –never before had a single currency been adopted by a group of politically independent countries.

My second point is about the effects of sovereign defaults in peripheral countries on core industrial countries. Put another way: to what extent have sovereign debt crises led to the outbreak of global financial crises? This point has some relevance to the topic of this conference, as it raises the question of the systemic consequences of a default –though we are talking about life with or without sovereign default in the periphery of the Eurozone, not the periphery as such. The simple answer to the question is: very rarely. In the 19th century, none of the Latin American debt crises of the 1820s or the 1870s, for example, triggered a global financial crisis (Marichal, 1989);[7] nor did the Ottoman debt crisis of 1876, which led to direct interference in Ottoman finance by the western powers through the Caisse de la dette publique ottomane (Thobie, 1977).[8] Even the Russian default in 1918 did not have catastrophic consequences, even though

6 Reinhart, Carmen, and Kenneth Rogoff (2009). This Time is Different. Eight Centuries of Financial Folly, Princeton, Princeton University Press.
7 Marichal, Carlos (1989). A Century of Debt Crisis in Latin America: from Independence to Great Depression, 1820-1930, Princeton, Princeton University Press.
8 Thobie, Jacques (1977). Intérêts et impérialisme français dans l'empire ottoman, 1895-1914, Paris, Publications de la Sorbonne.

it considerably weakened France's financial position in the aftermath of the First World War. In fact, between 1890 and 1990, only two sovereign debt crises could have led to a collapse of the international financial system: the Baring Crisis of 1890 and the International Debt Crisis of 1982 (Cassis, 2011).[9]

The Baring Crisis of 1890 has long been forgotten, but it was a case when a leading bank could have collapsed following a default in a peripheral country. In 1890, Baring Brothers was one of the two biggest investment banks (the other was the Rothschilds) in the City of London, and therefore in the world, and if it had been allowed to collapse, most of the City's big houses would fallen with them. The bank had over-committed itself in Argentina, where a serious crisis broke out in 1889-90. It was saved from failure at the eleventh hour by the London banking community, under orders from the Bank of England. A major international financial crisis was averted, but the shock was followed by several years of economic stagnation (Clapham, 1970; Ziegler, 1988).[10]

The international debt crisis in 1982 is better remembered. From the mid-1970s to the early 1980s, international capital movements were dominated by loans from commercial banks to Third World countries. These loans were fed by deposits from the oil-exporting countries, "petrodollars", income from which rocketed after the two oil crises in 1973 and 1978. Panic broke out in August 1982, when Mexico unilaterally declared a three-month moratorium on payment of its debt principal. A number of major banks, primarily American, were seriously exposed and even risked failure if there were defaults, threatening the financial system with paralysis or even collapse. A major banking crisis was averted when agreement was reached between the banks and the Latin-American countries. The banks rescheduled the debt and agreed to new loans; the Latin American countries accepted the International Monetary Fund's restructuring

9 Cassis, Youssef (2011), Crises and Opportunities. The Shaping of Modern Finance, Oxford, Oxford University Press.

10 Clapham, John H. (1970). The Bank of England. A History. Volume II 1797-1914, Cambridge, Cambridge University Press.;
Ziegler, Philip (1988). The Sixth Great Power. Barings, 1762-1929, London, Collins.

programmes; and the US monetary authorities acted as mediator and offered the banks guarantees. However, the crisis heavily penalised the Third World countries, whose standard of living took a decade to return to pre-crisis levels (Devlin, 1989).[11]

In between these two events, there were of course two periods –one with very few crises, the Bretton Woods era, and another with the highest occurrence of financial crises, the interwar years, and especially the Great Depression. This was the last time that sovereign defaults took place in core industrial countries, including one of the world's leading economic powers, Germany, which, moreover, was the world's largest borrower. This is not the place to discuss Germany's external debt following the banking crisis of 1931, the introduction of exchange controls and the advent of the Nazi regime in 1933 (James, 1986).[12] I would simply point out that sovereign default was a consequence rather than a cause of the world economic depression and very much part of what has been aptly called the Thirty Years War of the Twentieth Century. The same can be said of Austria and, to a lesser extent, of other small central and eastern European countries, such as Hungary, Romania, or Bulgaria.

Sovereign defaults had limited global consequences before 1914 because, on one hand the biggest borrowers (the United States, Canada and Russia until 1918) did not default; and on the other hand, foreign government bonds were held by individual investors rather than large financial institutions. Banks served as intermediaries and were only exceptionally threatened with collapse. As The Economist put it in November 1890: 'Had Messrs Baring Brothers been able to shift the burden of their South American obligations upon the investing public they would now have been standing erect.' This is of course the big difference with the International Debt Crisis of 1982. This time, it was the banks that were on the front line, which posed systemic risks and required a different type of intervention.

My third and last point is the monetary context. Sovereign defaults

11 Devlin, Robert (1989). Debt and Crisis in Latin America. The Supply Side of the Story, Princeton, Princeton University Press.
12 James, Harold (1986). The German Slump. Politics and Economics 1924-1936, Oxford, Clarendon Press.

have been more common under fixed than under flexible exchange rate regimes. This has less to do with the type of monetary regime than with the fact that defaults were more frequent before 1914, the classic age of the gold standard, because they carried far less systemic risks. Defaulting countries in the periphery would as rule leave the gold standard and return at a later stage, usually with a depreciated currency. This was for example the case of Argentina between 1876 and 1883, and again between 1885 and 1899.

Fixed exchange rates are of course different for monetary unions. There were, however, monetary unions before 1914. The best known, though it has also been forgotten, was the Latin Monetary Union, formed in 1865 between France, Belgium, Italy and Switzerland (Einaudi, 2001).[13] The purpose of this convention was in fact rather limited: to reach agreement on the proportion of silver contained in the low-denomination coins of the four countries. The Union officially lasted until 1923, though it was de facto broken by the First World War, and it survived two suspensions of gold convertibility of the Lira. Moreover, Italy always had access to the international capital market, because of its commitment not to default on its external debt, and the support of the Rothschilds (Tattara, 1999).[14]

So in some respects it seems that we have seen it all before, in others that the current situation is entirely different. The lessons of history are more complex than it is sometimes tempting to believe. Some practical lessons can be drawn from the recent past and in this context, it is astonishing that only scant attention has been paid so far, from the creditors' point of view, to the International Debt Crisis of 1982 –an event which is just starting to belong to the historical past. The lessons of history are of a different order. History helps better understanding present events, not least by putting them into perspective –the risks of sovereign default in the Eurozone and their possible consequences look different when considered not only in

13 Einaudi, Luca (2001). Money and Politics. European Monetary Unification and the International Gold Standard (1865-1873), Oxford, Oxford University Press.

14 Tattara, Giuseppe (1999). 'Paper money but a gold debt: Italy in the Gold standard', Working paper, Università degli studi di Venezia, Dipartimento di scienze economiche.

the short term, but also over the longer term.

12
The European Crisis: A View from the Market

Erik F. Nielsen

Market participants rarely agree on the effects on assets prices and exchange rates of economic and political events, but the degree to which they have disagreed on key aspects of recent years' European crisis is extra-ordinary in several aspects. Roughly speaking, one can identify at least three dimensions to the market's views of the Eurozone crisis: First, the majority of US and UK based investors – as opposed to the vast majority of Continental European and institutional Asian investors - initially saw the crisis as existential for the Eurozone; i.e. (in the "Anglo-Saxon" interpretation) this was the beginning of the inevitable break-up of the Eurozone. As a result, the early stage of the crisis was characterised by the sell-off of the euro, but as time went by and senior European policymakers made clear that they stand behind the European project and as no serious voice emerged anywhere in the Eurozone arguing for anyone abandoning the Euro, this view began to fade. As a result the Euro has strengthened recently even as more countries— Ireland and Portugal — received rescue packages.

Second, there has been an important difference in the approach to

the analysis of the crisis between "traditional G-7 investors" and "dedicated EM investors", with the former group originally underestimating the severity of the fiscal crises, while the latter group – being more experienced in debt sustainability analysis – more accurately saw the severity of the sovereign debt dynamics. However, the latter group typically underestimated the determination (and power) of the official sector, particularly the ECB.

Third, so-called "real money" investors reacted differently than hedge fund investors, as the former group originally appeared too dependent on the credit ratings agencies and the agencies' late recognition of the underlying weaknesses in parts of the periphery. As the downgrades began to roll along (at an impressive speed) real money managers often got caught and began to hedge themselves in the CDS market, accelerating the spread-widening which further complicated matters for the sovereigns.

On the back of these broad characterisations of groups of market participants, I'll focus on three aspects of the crisis, namely the causes of the crisis; the policy responses to the crisis; and the issues which need to be addressed to create a sustainable solution for the Eurozone. These three aspects are of particular importance as market participants – with their varying backgrounds and mandates - continue to engage in the eternal probability game: Trying to interpret new information – economics, financial and political - as it became available with a view to guessing the impact on asset prices and exchange rates.

The causes of the crisis:

Most importantly, one must recognise that the crisis was triggered not by one or two single events, but by an unfortunate combination of several factors. I can think of at least five such factors, all of which would need to be addressed to lower the probability of another crisis coming around. In no particular order:

First, the world's key central banks kept interest rates too low for too long, providing a period of too cheap money for too long. It is not clear to me why the world's central banks made this mistake, but the

last 10-15 years of inflation targeting may be part of the explanation as the focus was on headline (or core) inflation during a period where Europe (and the US) imported significant disinflation from emerging markets and therefore mostly dismissed the excessive credit growth even though it fuelled asset price bubbles. In Europe, cheap money fuelled housing in most countries and – further powered by the collapse in sovereign spreads following the adoption of the euro – the entire Eurozone periphery saw excessive increases in public sector wage bills (as their interest bills fell with lower rates), fuelling private sector wage growth and a de-link of wages from productivity; the now much discussed explosion in unit labour costs.

Second, credit rating agencies proved insufficient in understanding the underlying imbalances as they developed in the periphery. Most importantly, the creditworthiness of sovereigns inside the Eurozone was (apparently) misunderstood, as was the importance of private sector balance sheets. (For good order, the ratings agencies were not the only ones misjudging these developments.)

Third, insufficient regulation and supervision of the financial sector added to the underlying problem of too easy money as leverage grew quickly. And the decentralised supervisory regime inside the Eurozone aggravated the problems.

Fourth, regardless of the macro and regulatory environment, in several cases, individual financial sector participants did not have sufficient internal risk management processes in place to shelter their institutions from adverse developments. As a result, public money had to be employed in several places to prevent systemic risks from developing.

Fifth, official statistics proved insufficient. Greece is the extreme case, of course.

The policy responses:

Many market participants and commentators have been critical of the policy reactions both with respect to speed and content. I mostly disagree. Within the realm of political reality I give high marks for

the European policy reaction functions. Of course, if one disregards normal processes of checks and balances in democratic systems, in particular with respect to the commitment by politicians of taxpayers' money, then one can usually come up with faster (and sometimes better) solutions to emerging problems. Also, with the strength of hindsight, one can often identify better long term solutions. But, in my view, within the boundaries of political and legal realities, the ECB and key governments, as well as the Commission, reacted well – and sufficiently – to avoid the ultimate financial disaster of a "European Lehman Brothers" event. The often-heard interpretation of policymakers "kicking the can down the road" (used to argue for taking the presumably inevitable debt restructuring up front) is misguided in my opinion. A better narrative would be that policymakers are "buying time" to both provide the crisis countries with an increased (if – in some cases – still small) probability of sufficient adjustment to avoid a debt restructuring, and for the creditors to provision appropriately and hence prepare for a future possible scenario of debt relief. And indeed, along the way, several countries, including Greece, Ireland and Spain have implemented impressive reforms to address the underlying weaknesses.

In my opinion, the one valid concern about the policy reactions relates to the ECB. While I fully compliment them for their first injection of unlimited liquidity, for their fixed-rate-full-allotment policy (instead of more traditional quantitative easing) and for their purchases of sovereign debt in secondary markets, one must recognise that in doing so, the ECB has taken on a quasi-fiscal role (like several other major central banks), which must be reversed at the earliest possible opportunity. Also, the ECB is now a member of the so-called Troika (along with the Commission and the IMF) in setting policy conditionality and monitoring programs when bail-outs have been agreed. As such, the ECB has taken on a role somewhat like a "European IMF". Beyond the most urgent situation, this is not an appropriate role for a central bank, and it should be phased out as soon as possible.

What should be done?

Finally, let me turn to the issue of what needs to be done for the

Eurozone to survive and – indeed – prosper in the longer term. First, much ado has been made of the claimed inevitability of introducing a degree of fiscal federalism, i.e. tax sharing, between Eurozone member states. Clearly, for the foreseeable future, this is politically impossible. But even if politically feasible, would it be economically desirable? I am not convinced. The experience from other currency unions with greater fiscal transfers is hardly encouraging in terms of getting the weak parts to adjust, as illustrated in Germany, Belgium – and in the US. In contrast, lending money – possibly in combination with debt service relief either through concessional terms or outright debt write-offs – in return for good policy reforms have had a number of successful outcomes. Indeed, there is no substitute for policy reforms to create internationally competitive economies with prudent fiscal policies – and hand-over of unconditional money is certainly not one.

In the Eurozone, policies need to be better coordinated, and coordination needs to include attention to private sector balance sheets, competitiveness etc, as is now well recognised. But while the new framework for such coordination is welcome, it will always be subject to domestic politics. Therefore, in the longer term, markets need to play their role in terms of pricing different risks differently and in accordance with the underlying fundamentals. And it must be possible for any borrowing entity – a government, a local entity, a bank, a business, a household – to be allowed to default. A market-based economy will not allocate capital efficiently unless lenders know that money can be lost, thereby guiding the pricing of their loans correctly.

The ECB needs to play a more active role in this respect. Specifically, securities accepted by the ECB in its repo operations must be rated according to their true creditworthiness so greater differentiation of haircuts should apply. This cannot be implemented in the middle of the crisis, but longer term, the ECB cannot continue to treat almost identically sovereign credits with vastly different underlying fundamentals. A properly differentiated policy on haircuts will help drive spreads at an earlier stage than in the past (and hence help encourage policy adjustments at an earlier stage) both because of its direct

impact on the cost of repo'ing, but also because of the signal it sends to market participants.

These are not huge changes to the Eurozone structures, and they don't need to be. More than two thirds of the Eurozone economy remains in fundamentally good shape, based on reasonably flexible markets and a generally competitive private sector, which has kept a savings surplus big enough to cover the public sector deficit. The crisis in the Eurozone is a reflection not of a fundamental flaw in the system but of past excesses and lack of reforms to adapt to the new globalised world in no more than 10%-20% of the Eurozone economy. Such a crisis calls for fine-tuning of the set-up; not of a major overhaul.

13
How the EU Wants to Solve the Crisis – and Why This is Not Going to Work

Wolfgang Münchau

I think I now understand how the EU is planning to resolve the crisis.

As a starting point, I believe that Angela Merkel will honour her pledge not to force debt restructuring until 2013. The German chancellor agreed this formula with President Nicolas Sarkozy of France during their infamous walk on the beaches of Deauville in France. She is serious about this pledge, and has told aides that she will not renege.

While politicians have initially believed that Greece may just pull through on the basis of austerity alone, there is now an emerging consensus – though not held by central bankers – that the Greek public sector debt is not sustainable. For this realisation to look consistent with Ms Merkel's pledge at Deauville, the most likely route chosen will be a voluntary restructuring that involves a maturity transformation of Greek bonds. A voluntary restructuring, of course,

is an oxymoron, like German diplomacy. The idea is to get a group of large investors into a room, and bang heads. The problem is this will almost certainly not be sufficient, and will raise all sorts of free rider and moral hazard issues. Involuntary restructuring was a disaster in pre-default Argentina, and in fact may have contributed to the default in the same year. It worked in Uruguay, but under different conditions. Uruguay was considered solvent, but faced a liquidity squeeze. Greece is considered insolvent, but has sufficient liquidity for the time being.

In the case of Greece, debt sustainability would require a large restructuring. The projected debt to-GDP ratio will reach 160% in 2012. There would be no point in a haircut of 10 or 20 percentage points. A haircut – or an equivalent debt restructuring – would have to be of sufficient size to persuade even sceptical investors that the Greek debt would be sustainable post-restructuring. A 50 per cent haircut would probably do the trick, and would still require significant fiscal and economic reform, but at least Greece would have a more realistic chance to pull through.

But while a voluntary scheme is insufficient, it may work politically, and it may in fact be a pre-cursor for a political vote to release the next tranches of the existing loan, and to renew the loan in 2012. Under the old agreement, Greece is supposed to return to the capital market in 2012, but this is wholly unrealistic. Greece will need a follow-up programme, which would require some token gestures that the private sector participates.

So this is how I could envisage the sequence of crisis resolution in the Eurozone. After the initial loan, a token voluntary bail-in would be followed by a follow-up loan in 2012. By that time, the exposure of the private sector will be lower than today. The short term debt will have been fully repaid.

Once we reach 2013, the same considerations will apply as they do today. Default would cut the country off from the capital markets for several years. It would risk contagion to other countries. It would require a recapitalisation of the ECB, and trigger immediate trans-

fer payments under the rescue umbrellas. My hunch would be that the next generation of political leaders will be just as cautious about default in 2013 as the present generation is in 2011. They will give Greece, Ireland and Portugal another bridging loan. By 2015, a large chunk of the peripheral debt will be held by the EFSF and the ESM. Collective action clauses, investor bail-ins, all of that will be irrelevant. There will be no private sector left to bail-in. The privates will have bail-out by then.

By that time, there will be few Greek bonds left. Most of Greece's debt will be in the form of an EU/EFSF/ESM credit. This alone will not make the Greek debt any more sustainable, but it allows some flexibility in the debt management. The loans may be extended to 50 years, and the interest rate may be cut towards zero. In extreme, you could envisage a perpetual zero-coupon loan – in other words a complete debt forgiveness.

Once the EFSF/ESM end up with all the periphery debt, its own bonds will serve as a proxy for periphery debt. Over time, I would expect that the European Council will extend the size and remit of the ESM from the pure backstop it is now towards a proper debt agency, which will gradually absorb all debt. This may become necessary to stop further contagion.

Even Spain may eventually come under this umbrella, as I suspect the adjustment of Spain will be much harder than currently acknowledged. On my calculations, Spanish house prices have a further 20- to 30% to fall, and so will real incomes. This process will happen slowly, maybe over a decade. But it will wipe out large chunks of the country's savings banks sector. I therefore expect a future ESM/IMF programme for Spain as well.

At that point the focus will shift to Italy. Italy accounts for 18% of the EFSF/ESM guarantees. I suspect Italy will not honour its bailout commitment if and when Spain were to enter the mechanism. Even if Italy were willing to honour its commitment, it might not be able to, given its own debt sustainability problems. And once Italy defaults on its commitment, I cannot see Germany and France willing

to bankroll the entire system unilaterally. At that point, the intra-governmental approach will break down, and the Eurozone will face a straight, and extreme choice: either make the big jump towards a common Eurozone bond, with a fiscal union, and an economic policy superstructure to mirror the ECB, or to retreat, and break up. Politically, the EU has always avoided extreme choices. But this is a luxury the Eurozone cannot afford given the dynamics of the debt crisis. So what will be the consideration of the next generation of EU leaders when faced with such a choice? Just think of the political dynamics at each node in this chain. The choice today is between crisis resolution, and kicking the can down the road. We are kicking the can. In 2013, the choice will be essentially the same. When it becomes impossible to kick the can any further, the stark choice will present itself. My guess is that, having kicked down the can, the EU will end up biting the bullet, once it realises that the alternative options are not all that much cheaper. It is not that they want this particular outcome. They will simply make the choice of least resistance at each node in the decision tree, and end up at this point.

Is this a good outcome? Think of it this way: The Eurozone would survive in one piece; there would be no blood on the streets, just a once-and-for-all, albeit reluctant bailout, accompanied by a limited fiscal union.

There is, I admit, a non-trivial possibility of a big game-changing accident. Ms Merkel may be serious about the Deauville commitment, but a revolt in the German or Greek parliament, or some other shock, may force a default.

Some of these accidents are electoral shocks, such as the near victory of the True Finns in the recent Finnish parliamentary elections. The new Finnish government will include two of three parties, which are advocating a partial Portuguese debt default as a condition for a rescue package.

Another accident is a revolt within Angela Merkel's increasingly fragile coalition. It looks as though the German chancellor is on the verge of losing her majority over the domestic legislation of the Euro-

pean Stability Mechanism (ESM), the long-term financial umbrella for the Eurozone. She may have to rely on the opposition to ratify the ESM, which may come at a heavy political cost.

Yet another accident would be a hasty debt restructuring – the result of political panic in Athens, or a vote in one member state not to pay the next tranche of the Greek credit. A premature Greek default would be a game-changing accident, and could provoke a crisis worse than Lehman Brothers. If the Finnish voted against the next tranche, and if Greece defaulted the next day, we would be in a scenario, in which the ECB's dire warnings of a financial Armageddon may prove correct.

Another accident would be a political hiccup in Portugal, where political leaders have been playing a game of hard to get. The Portuguese election on June 5 may once again fail to produce a government, and that would make it difficult for Portugal to adhere to a very stringent austerity and reform programme. The agreed programme includes extremely controversial issues such as reductions in dismissal days. This is not something a minority government could implement.

Another problem would be a ratification failure of the ESM in the German, Finnish or Dutch parliaments; or the refusal by the Greek parliament to accept the new privatisation and austerity measures; or a realisation that the Spanish cajas are in much worse shape than recognised, and that Spain cannot raise sufficient capital.

Another big accident waiting to happening is a downgrade threat for French sovereign bonds. I recall asking a French official about this issue, and got the smug answer that the rating agencies could hardly downgrade France if they maintained a triple-A rating for the US. That was before the threat of a possible US downgrade by Standard & Poor's. President Sarkozy's economic advisers are now recognising the problem, and have advised the president to do everything in his power to maintain the triple-A rating, including an austerity package. A downgrade of France would destroy the logic of the EFSF. It is built on guarantees by the triple-A countries. Without France, the lending ceiling of the EFSF would melt down further.

The list of potential accidents is long. They share a joint theme - serial political crisis mismanagement.

My best guess is that the Eurozone will fudge the many crises that will yet break out, but once they reach the point of unfudgeability, they will jump towards a closer union, because the other jump is too risky, and potentially extremely unpleasant. There is no guarantee that it will be happening, and even if it is happening it will not be a happy monetary union, with strong political pillars. It will be a somewhat toxic monetary union, but it will be stronger than today's.

POSTSCRIPT

The EU in 2013: Debt Defaults and More?[1]

Janet Kersnar

It's summer 2013, and Greece is basking in praise. After three grueling years meeting the terms of its multibillion euro bailout loan package from other European Union members and the International Monetary Fund (IMF), and pursuing austerity measures that have frozen public-sector pay and decimated state spending, the Mediterranean country has chipped away at its debt and been allowed back into the international financial markets with open arms. European leaders, meanwhile, are also congratulating themselves for preventing a banking crisis by holding Greece to the pledge it made back in 2010 that it would pay back all of its debt on time. Greece's biggest creditors -- northern European's overstretched financial institutions -- are heaving a sigh of relief since they have had time to hedge their exposures to Greek debt after receiving EU assurances that until 2013, none of the coupons on the sovereign debt they have been holding will be cut.

As summer 2011 begins, many experts are not convinced that the

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"official," happily-ever-after version of the EU's debt crisis will play out. Even as European finance ministers weigh up whether Greece is meeting its current targets to receive the next tranche of the bailout package, there are a number of other "endgame scenarios" in which Greece restructures its debt either before or after the terms of the 110 billion euro rescue expire in June 2013. None are ideal, and "all come at a cost," said Lee C. Buchheit, a New York-based lawyer at Cleary Gottlieb Steen & Hamilton, who participated as a panelist with other banking and finance experts during a Wharton co-sponsored conference held at the European University Institute (EUI) in Florence, Italy. The event was titled, "Life in the Eurozone: With or Without Sovereign Default?"

"What I'm hearing here sounds an awful lot like what we were hearing in the U.S. after the Bear Stearns bailout," noted panelist David A, Skeel, a law professor at the University of Pennsylvania. "It's what many economists were calling 'constructive ambiguity.' If you don't know you're going to be bailed out, that's a good thing, because you will act as if you're not going to be bailed out. In the U.S. in 2008, constructive ambiguity proved to be a complete failure. Everyone assumed the worst, and acted as if the best was going to happen," he said. "That's where we are in Europe now. People keep saying that in 2013, there are not going to be any more bailouts. Unless something dramatically changes in the next two years, that's not a credible promise at all, and we should act as if it is not a credible promise."

With Ireland and Portugal also receiving bailout packages of their own in recent months -- and bets being taken for when or whether Spain and Italy will go the same route -- the word "restructuring" does not receive the same reaction of alarm, or "paralyzing fear," that it did a year ago, Buchheit added.

A Will and a Way

According to Buchheit and other conference participants, any scenario that does not involve Greece defaulting looks less and less realistic. For one thing, Buchheit noted, if Greece hobbles to 2013 without restructuring, it can't expect to be embraced by the public

markets as it once was -- back when investors "to their regret today, failed to conceive of any credit differences between Germany and Greece" and piled into Greek sovereign debt. Forecasters predict that Greece's public sector debt-to-GDP ratio in 2013 will be between 150% and 170%, compared with 143% at the end of 2010 -- which at the time was the highest in the EU and more than double the 60% ceiling EU members have agreed to maintain under the Maastricht Treaty.

In 2013, Buchheit said, more than half of that debt will be held by the so-called "official" sector -- the EU, the IMF and the European Central Bank (ECB), which has been buying big chunks of the Eurozone's "peripheral" countries' debt on the secondary markets. The official sector will be able to claim "preferred creditor status" ahead of other creditors, Buchheit noted, leaving investors in private capital markets out in the cold should Greece's economy teeter again.

"So is it cheaper to have Greece default, or hand Greece the money?" asked panelist Arnoud Boot, corporate finance and financial markets professor at the University of Amsterdam. Ultimately, he added, "these are political questions" that have more to do with the wherewithal of Greece's politicians than with finance and economics.

Franklin Allen, Wharton finance professor and co-chair of the conference, agreed. "Projections [suggesting] that [Greece is] going to spend 5% to 10% of GDP on interest payments alone are just not going to happen," he said in an interview after the event. "I just don't think they have the political will to go out and tax people and cut expenditure in a way that would generate 5% to 10% of GDP," not least because Greece's economy has been contracting since 2008, and a -3% GDP is forecasted for 2011. At some point over the next few years, he predicted, Greece's debt will climb to around 340 billion euros, and the country will have to restructure its debt by either writing off a portion of it or rescheduling repayments, potentially forcing banks to accept heavy losses and triggering a larger crisis across the region's financial sector.

Therein lies the rub. "This isn't a debt problem," observed Charles

Calomiris, professor of financial institutions at Columbia University's Graduate School of Business in New York. "This is a debt problem with a banking problem -- and one where a run on [Greece's] banks will make the crisis come to a head. How do you stop that once it starts?" Were the balance sheets of Greece's banks to crumble as investors and customers fled, "the big problem is: Who is going to put up the money to save the Greek banks?" asked Allen. "If that's a big enough number, and no one is willing to come up with the money, then Greece will leave the Eurozone. They need to be able to print money so that the banks don't go bankrupt."

But that's a scenario EU politicians -- the most vocal being Prime Minister Angela Merkel of Germany, one of Greece's biggest creditor nations -- refuse to acknowledge. "Politicians are very reluctant to discuss that as an option," said Allen. "But that's what has happened historically. With the gold standard, if you got into trouble, you got off the gold standard, sorted yourself out and then got back in. That's what they don't seem to understand."

Solidarity or Bust?

It's a perplexing situation, said Calomiris. As more and more public money is poured into the bailouts, European officials refuse to entertain the thought of any of the 17 Eurozone members leaving the currency union, despite the drag on the long-term competitiveness of individual members and the growing unhappiness of their citizens living under the constraints of the euro. "And you're doing all that because you really love this European idea," he said. "The change to the euro is first going to happen as a redenomination of the banks' liabilities. I predict the end of the Eurozone as we know it."

Calomiris's comments raised some audible consternation in the audience in Florence. But he was not alone in foreseeing Eurozone exits, with or without defaults. For example, in an op-ed published in December on Bloomberg.com, Elena Carletti, an economics professor at the EUI and a conference co-chair, wrote that the EU's politicians have spent month after month debating whether to include collective action clauses in Eurozone debt contracts, to the detriment of

tackling the EU's larger crisis issues. "These clauses, which make debt restructuring faster by forcing minority bondholders to accept the terms agreed to by a majority of creditors, are no doubt important to include, but are a distraction from what is likely to be the main issue, namely financial stability,"Carletti wrote. What is the best option for a country like Greece?

According to Carletti, it's either a quick default or an exit from the Eurozone, perhaps temporarily, with a market-determined exchange rate between the new currency and the euro."The great advantage would be for the defaulting government to regain control of monetary policy and potentially be able to guarantee the banking system. There would be inflation, but this, together with the devaluation of the local currency, would help the country to grow by boosting exports," she wrote.

Part of the challenge for the EU, if it wants to avoid the costs of future rescue funding like that of Greece -- and moral hazards of making defaults too tempting for member countries -- is that there is no bankruptcy framework to follow, said Skeel. "The problem in bankruptcy ... when you're dealing with sovereigns is that you don't have the stick that we have in normal bankruptcy proceedings," he noted. "In normal proceedings, there's direct liquidation -- you're just going to shut everything down if bankruptcy doesn't work. You can't liquidate a nation."

Skeel recommended that the EU adopt a "rules-based" bankruptcy framework, similar to what he and Patrick Bolton of Columbia Business School developed in early 2004. A key part of the framework includes a "first in time" priority system to reduce the risk of debt dilution in a restructuring based on when bonds are issued. For example, investors with bonds from 2010 would have priority over investors with bonds from 2011. Higher priority bondholders would be paid in full; others would not.

A Peso for Your Thoughts

If there's good news for the likes of Greece, it's that history is littered

with examples of debt restructurings to learn from -- thanks to as many as 60 sovereign debt defaults in recent decades, according to Buchheit. What history shows, he said, is that a country has a lot of leeway in negotiations with creditors, as long as it does not discriminate against any of the creditors through legislation and it has a good justification for the negotiations. Managed efficiently and fairly, a default can take six months from beginning to end, he added.

Throughout the conference, references were made to various debt restructurings in Latin America. One recent default that often conjures up grimaces -- and is perhaps a lesson on how not to manage a default -- is Argentina's. Argentina is "a poster child for how a restructuring can be so terrible and so costly," said G. Mitu Gulati, a law professor at Duke University in North Carolina. Many factors led to Argentina's crisis and the government's decision in 2001 to default on $95 billion of debt to private creditors, the largest sovereign default in history. Ten years later, the country -- whose debt, like Greece's, was largely in bonds -- has struggled to return to international financial markets. "But the economists I meet with always tell me that you can't just look at one case; you have to look at the other cases," of which there have been as many as 60 in recent years, said Gulati.

Another example is Uruguay. When the country's government defaulted in 2003, it was days away from running out of money to repay its creditors. So it "re-profiled" its external bonds by extending the maturity of each of its 18 series of bonds by five years. There was no "haircut" on the principal and coupons were kept the same. Unlike Argentina, Uruguay was back in the international capital markets in 31 days, and has returned frequently since, noted Buchheit, who was an adviser on the Uruguayan default program.

The Trouble with Greece

As for Greece, it could do a "Uruguay-style" reprofiling, according to a paper published in April by Buchheit and Gulati. Getting creditors -- including many northern European banks -- to agree to stretch out the terms might require the official sector to provide some sort

of guarantee or collateral security.

According to Wharton's Allen, however, Uruguay has "a small enough problem, and they just needed more time to cut expenditure. The trouble with Greece is that time doesn't help them very much." Rolling over the debt, he said, "won't be enough to solve the problem. They need to get rid of more of the debt before they can start doing that.... But then somebody has to take the hit."

Despite the challenges ahead, Gulati pointed out that Greece has a number of factors working in its favor that other financially distressed countries don't have. One of those factors involves Greece's debt contracts. As much as 90% of its debt has been issued under local law, with the rest falling under U.S., Swiss and a handful of other jurisdictions. And unlike most loan instruments in other countries, Greece's do not have what's known as "negative pledge clauses," which prevent the use of assets to secure other loans. "Their contracts are actually set up to do a restructuring," he said. Whether intentional or not at the time of bond issuance, "the Greeks negotiated for a lot of flexibility. It's almost as if they knew as soon as they joined the Eurozone, there would be restructuring," he joked.

Using local legislation, Greece can put in an orderly mechanism for a voluntary exchange of debt, "the kind of thing politicians are saying does not exist," Gulati said. "If that's not what we want to do, then we have to go to other, much more painful solutions, where we're going to creditors and saying, 'We owe you a euro or a dollar, but we'll pay you a fraction thereof.'" Echoing Buchheit, Gulati argued that a steep haircut, say of 50%, was legally possible.

"The story cannot be that there is no mechanism," he said. "Greece is almost in a better position than any other country in recent memory to do a restructuring."

Legal issues aside, the EU political machine continues to work on a different outcome. On May 7, the finance ministers of the EU's "inner circle" of creditors initially vehemently denied press reports that they had met secretly in Luxembourg a week earlier to discuss,

among other matters, Greece's exit from the single currency. Later that weekend, however, the finance ministers issued a statement saying that they had been "called to participate for an exchange of views regarding the financial developments in Greece.... It is absolutely evident that in these talks, there was no discussion nor was any issue raised concerning Greece's participation in the Eurozone, as various foreign media outlets said irresponsibly and for their own reasons."

In or outside the Eurozone, Buchheit wondered whether it's the term "restructuring" -- "which connotes a degree of coercion on the affected creditors" -- that the EU is struggling with. Calling the solution "voluntary liability transaction management" might be more acceptable if action needs to be taken on Greece's debt before 2013. But call it what you will, Buchheit summed up his thoughts about the conundrum facing the entire EU -- creditors, politicians and taxpayers -- with an old joke about several people lined up before a firing squad. As the guns are drawn, one of them turns to another and asks, "Would you like to trade places?"

This book contains the proceedings of the conference
"Life in the Eurozone With or Without Sovereign Default?"
that was held at the European University Institute
in Florence on 14 April 2011.

EDITED BY
Franklin Allen (Wharton School, University of Pennsylvania)
Elena Carletti (European University Institute and CEPR)
Giancarlo Corsetti (University of Cambridge, EUI and CEPR)

With a Foreword by Josep Borrell Fontelles
(European University Institute)

AUTHORS
Edmond Alphandéry (CNP Assurances)
Arnoud W.A. Boot (University of Amsterdam)
Lee C. Buchheit (Cleary Gottlieb Steen & Hamilton LLP)
Charles W. Calomiris (Columbia University)
Youssef Cassis (European University Institute)
Mitu Gulati (Duke University)
Martin Hellwig
(Max Planck Institute for Research on Collective Goods)
Janet Kersnar (Knowledge@Wharton)
Ramon Marimon (European University Institute)
Wolfgang Münchau (Eurointelligence)
Erik F. Nielsen (Formerly Goldman Sachs)
Fabio Panetta (Bank of Italy)
Helmut Siekmann (University of Frankfurt)
David A. Skeel, Jr. (University of Pennsylvania)
Karl Whelan (University College Dublin)

ISBN 978-0-9836469-1-4 (e-book version)