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Article

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CESifo Forum

Provided in Cooperation with:

Ifo Institute – Leibniz Institute for Economic Research at the University of Munich

Suggested Citation: Franz, Wolfgang; Fuest, Clemens; Hellwig, Martin; Sinn, Hans-Werner (2010) : A Euro Rescue Plan, CESifo Forum, ISSN 2190-717X, ifo Institut für Wirtschaftsforschung an der Universität München, München, Vol. 11, Iss. 2, pp. 101-104

This Version is available at:

<https://hdl.handle.net/10419/166398>

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A EURO RESCUE PLAN

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In light of the gravity of the European debt crisis and the radical measures that were decided on in May 2010, we feel obliged to make this public appeal to the German federal government, in which we set out basic considerations for the pending negotiations for the reform of the euro area. In our opinion, these considerations are essential for the survival of the European Monetary Union.

The euro is a key element of European integration, but it will be endangered if we do not succeed in establishing more fiscal discipline in the future. What Europe needs is not an economic government but political and economic mechanisms that effectively limit public and private indebtedness in the member states. It needs these mechanisms not only to stabilise national finances and the common currency but also to achieve a better balance of growth forces in Europe.

The present crisis is not a currency crisis. Interpretations that regard the devaluation of the euro *vis-à-vis* the dollar as a currency crisis are pure hysteria. The devaluation is only a partial correction of the overvaluation of the euro relative to OECD purchasing power parity that had been building up since 2003. The improvement in competitiveness for Europe's exports on international markets that comes with the devaluation should be welcomed by the countries in Europe, especially since they have not yet recovered from the recession. However,

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almost half of German exports are to the euro area and thus not immediately affected by the devaluation of the euro – just as they were also not affected by the foregoing revaluation. As originally intended by its founders, the European Monetary Union has contributed to immunising the real economy against exchange rate fluctuations.

The current crisis is due to the debt and financing problems of some euro member states. The introduction of the euro induced a convergence of interest rates in the eurozone countries. As of 1995 the initial members of the European Monetary Union (except for Germany) had to pay interest rates on their government bonds that were on average 2.6 percentage points higher than the rate on German government bonds, in some cases even 6 percentage points higher. With the introduction of the euro this interest premium disappeared almost completely. A common capital market was created that provided favourable financing conditions of a kind that especially the countries on the southwest periphery of Europe had not known previously. These favourable conditions applied to both public and private debtors. As a result there was a huge capital flow to these countries that induced a boom in construction and investment. However, effective mechanisms for limiting public and private debt were lacking. In many countries the booms in construction activity developed into speculative bubbles. The bursting of these bubbles is now threatening the solvency of banks. This has resulted in considerable risks for the public finances of some countries. Current government deficits in Ireland, Greece, Portugal and Spain amount to more than three times the level allowed by the Stability and Growth Pact (3 percent of GDP). In Greece, the problem is exacerbated by an already very high level of government debt.

In the international discussion on sharing the burdens from the crisis, the claim is often made, particularly by the French, that Germany was the main economic beneficiary of the single currency, the high German trade surplus being a reflection of the trade deficits of the other euro countries. The only truth in this statement is that the booms in construction and



investment in the countries of the periphery caused inflation there that reduced the price competitiveness of these countries and led to external trade deficits. In Germany the reverse situation was true. A large part of savings was channelled abroad through the banks and relatively little money was invested at home. Domestic demand weakened, and wages and prices increased only slowly. This improved the price competitiveness of the country, and led to a large external trade surplus. This trade surplus was the counterpart in the real economy to the capital flows out of Germany.

In the current political discourse, those who regard the trade surplus and the combined loss of investment capital as a sign of Germany's strength display an almost tragic misunderstanding of the underlying economics. Germany's net investment rate from 1995 to 2008 was the lowest of all OECD countries. In 2008 only 40 percent of savings in Germany was invested in the country itself. Economic growth was correspondingly low. For 1995 to 2008 as a whole, real growth in Germany was 22 percent, almost the lowest in the entire OECD. In contrast, during this period economic growth amounted to 33 percent in Portugal, 56 percent in Spain, 61 percent in Greece and an impressive 124 percent in Ireland.

In principle, the flows of capital out of Germany can be seen as part of a useful convergence process in Europe, which has also benefited German savers and property owners. However, these flows were excessive. Too large a part of savings flowed out of Germany and into the countries of the southwest periphery of Europe. The resulting trade imbalances, which gave rise to large imbalances in external trade, were too high. The dynamics of the German economy, in contrast, were impaired.

This critical assessment is based not only on the observation that the construction and investment boom degenerated in part into a speculation bubble and that individual member states are now caught up in a debt crisis. It is mainly based on the assessment that even before the crisis broke out there were insufficient constraints on public and private borrowing.

Markets and prices did not sufficiently take into account the risks of investments. It was evident for some time that the government bonds of different member states, for example, did not all have the same degree of creditworthiness. Prior to 2008, however, investors did not demand interest premiums from

member states whose budget policies created default risks for their government bonds. No sanctions were imposed on the violators of the European Stability and Growth Pact, neither from the capital markets nor from officials in the European Union.

It was not until the 2008 financial crisis that interest rates on government bonds began to include premiums for default risks. Contrary to what some of the debtors have suggested, this is not reprehensible but is actually necessary for the long-term survival of the euro. The risk premiums are indeed much smaller than in the pre-euro era, but they help re-impose the fiscal discipline that had been lacking and they are fundamentally necessary for the functioning of the eurozone capital market. Capital flows are slowed down, government debtors are effectively disciplined and an overheating is avoided. It can now be expected that more capital will remain in Germany and will be available for investments in construction and in the rest of the economy. Domestic demand in Germany should become stronger and growth will accelerate again. And, of course, the external trade surplus should decrease again.

The rescue decisions made by the Council and the member states on 9/10 May, however, suspended the no-bailout stipulation of the Maastricht Treaty in order to prevent a default by Greece and possibly other member states on their public debts. Without passing judgment on these decisions, we are nevertheless convinced that these measures should not be extended in the present form beyond the agreed period of time. Maintaining them would further destabilise the eurozone. The recent packages foresee the complete bailout of creditors without requiring them to bear any part of the risks they had taken on. Sparing the creditors would again lead to carelessness in their lending policies and to an excessive degree of interest-rate convergence. The disciplining function of the capital markets would again be undermined, and the incentive to keep government budget deficits under control would be weakened. German voters are not likely to accept such a *carte blanche* guarantee for other countries. A regime in which Germany is obligated to pay for other countries' debts could endanger the euro if not European integration as a whole. Even if this prevents further crises, the imbalances in foreign trade and in capital flows would be perpetuated, with negative consequences for German economic growth.

Proponents of a continuation of the rescue policies argue that the associated lowering of interest rates

will allow those countries with high private and public indebtedness to reduce their deficits faster in the current crisis. But the highly indebted countries in the eurozone have already gained considerable relief from the rescue packages. Going beyond this and having additional interest-rate convergence induced by continued joint liability would be damaging. Many member states already received considerable relief from lower interest rates when the euro was introduced. But they did not redeem their debts as a result. Evidently, the effects of lower interest burdens were weaker than the incentives for additional debt financing that went along with lower interest rates – and with reduced capital market discipline. It was not until the current crisis made interest spreads grow again and imposed constraints on new borrowing that policymakers are now seriously attempting to limit state indebtedness.

For this reason it would be a grave mistake to introduce eurobonds, i.e. common government bonds of all states of the eurozone, as some countries are currently proposing. This would perpetuate the mutual bailout principle and would ultimately destroy the institutional basis for a sound fiscal policy in Europe.

Before the rescue package expires, policymakers must develop a viable concept for future fiscal-policy rules in Europe. This concept must contain two elements: more effective political constraints on government deficits and debt and most importantly a quasi-insolvency procedure for member states. The quasi-insolvency procedure is intended not only to help overcome future crises. It should also ensure that the member states keep their debt under control and that the financial-market participants proceed with greater caution. It is essential that the rules of the quasi-insolvency procedure be credible. The institutions responsible for enforcing these rules must be willing to do so effectively. Unlike the Stability and Growth Pact or now with the no-bailout stipulation, the rules must not be circumvented the moment they are intended to take hold.

In order to understand the conditions under which such a quasi-insolvency procedure would function, it is helpful to ask why even the German federal government agreed to the euro rescue plan in the current crisis, despite its violation of the Maastricht Treaty. Political pressure from the highly indebted countries certainly played a role. But the decisive factor behind the German government's acceptance of the plan seems to have been the fear that a sovereign default

in the eurozone would trigger a general capital market crisis with concomitant bank failures and yet another financial and economic crisis. Regardless of whether this fear was ultimately justified or not, the risk itself was regarded as too large. As it turned out, the eurozone was not prepared for this situation. The lack of preparation contributed to the emergence of the crisis because investors knew that the eurozone, in the case of the over-indebtedness of an individual member state, would hardly risk a formal default. Because the no-bailout stipulation was not credible, these states could take on much more debt, without the interest rates reflecting the risks.

In order to enforce government budget discipline in Europe, the capital markets must receive credible signals that in the case of one country's over-indebtedness, the creditors bear liability before help from EU or other member states can come into play. This sequencing is essential for inducing creditors to be cautious when granting loans. But this sequencing is only credible if there is no risk that the losses that the creditors must bear will not set off a general financial and economic crisis.

For this purpose, the capital requirements of the banks should be increased. If the government bonds of highly indebted countries must be backed up with more capital, this in itself will ensure that lending to these countries will be reduced or that higher interest premiums will be required. It is also necessary to have a simple, transparent, and rule-determined procedure for the restructuring of public debts. Only with such a procedure can one expect that a sovereign default will not induce a financial panic.

To enhance the credibility of rules for crises it is necessary to significantly strengthen the EU's competence for enforcing budget discipline both before and during a crisis itself. This competence should be assumed directly by the European Commission. In the present crisis the Commission did not perceive its intrinsic interest as lying in the enforcement of the Maastricht Treaty but in the expansion of the EU's competence that came with the bailout measures. If the Commission is given the competence for the determination and enforcement of the conditions under which aid is granted, it will perceive its own interest to lie in exercising this competence when a crisis occurs.

How should the fiscal-policy rules for the eurozone be reformed? In our opinion, the following ten points are necessary:

1. Distressed countries can expect help only if an imminent inability to fulfil its financial obligations is unanimously confirmed by the countries providing the help together with the IMF.
 2. Assistance can be provided by covered bonds bearing interest, or by loans, the yield of which must be set at a reasonable percentage (possibly 3.5 percentage points) above the European average. The loans must not exceed a given percentage maximum of the distressed country's GDP.
 3. At the same time assistance is granted, the original creditors must waive a portion of their claims through a so-called 'haircut'. The maximum percentage to be waived must be clearly defined beforehand, in order to prevent a panic-fuelled intensification of the crisis. A reasonable haircut would be 5 percent per year since the issuance of the respective government bond. This would limit the interest premium demanded upfront by the creditors to a maximum of around 5 percentage points. In addition, an extension of maturity could be considered for bonds with less than three years to maturity. The crucial factor is to provide the capital markets with a clear calculation framework.
 4. The budget of the countries facing quasi-insolvency must be placed under the control of the European Commission. Together with the country in question, the Commission would work out a programme to overhaul the state's finances, including reforms aimed at strengthening economic growth. Disbursement of rescue funds must be contingent on compliance with the conditions set forth by the rescue programme.
 5. This quasi-insolvency process must under no circumstances be undermined by other assistance systems that could provide incentives for opportunistic behaviour, in particular by such mechanisms as the eurobonds, i.e. commonly issued government bonds, favoured by some of the overly indebted countries. Eurobonds entail an across-the-board equalisation of interest rates regardless of the creditworthiness of each debtor country and, for that reason, would be tantamount to a subsidy to capital flows to those countries. Eurobonds would give *carte blanche* to new debt excesses, in addition to exerting negative effects upon economic growth in Germany. A particular risk in the coming negotiations is that Germany will be pressured to accept eurobonds in return for a quasi-insolvency procedure.
- It is also necessary, in our opinion, that the political limits to public debt be strengthened by rules along the lines of the Stability and Growth Pact. It must be stressed, however, that these limits cannot substitute for the discipline imposed by the markets through the interest spreads resulting from the individual countries' creditworthiness. The following provisions should be established:
6. The deficit limit set by the Stability and Growth Pact should be modified in accordance with each country's debt-to-GDP ratio, in order to demand more debt discipline early enough from the highly indebted countries. As an example, the limit could be tightened by one percentage point for every ten percentage points that the debt-to-GDP ratio exceeds the 60-percent limit. A country with an 80-percent debt-to-GDP ratio, for instance, would be allowed a maximum deficit of 1 percent of GDP, while a country with a 110-percent debt-to-GDP ratio would be required to have a budget surplus of at least 2 percent.
 7. Penalties for exceeding the debt limits must apply automatically, without any further political decisions, once Eurostat has formally ascertained the deficits. The penalties can be of a pecuniary nature and take the form of covered bonds collateralised with privatisable state assets, and they can also contain non-pecuniary elements such as the withdrawal of voting rights.
 8. In order to ascertain deficit and debt-to-GDP ratios, Eurostat must be given the right to directly request information from every level of the national statistics offices and to conduct independent controls on site of the data gathering procedures.
 9. Finally, in case all the above assistance and control systems fail and insolvency approaches, the country in question may be asked to leave the eurozone by a majority of the eurozone members.
 10. A voluntary exit from the eurozone must be possible at any time.
- We are Europeans by conviction and favour the further integration of the EU. However, we firmly believe that the European model will fail if it does not manage to strengthen once again the individual responsibility of the countries of Europe. For this reason we see no alternative to the proposals we have outlined here.