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The Euro Area Crisis Management Framework: Consequences and Institutional Follow-ups*

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27 September 2010

Abstract

The current instruments in the EU to deal with debt and liquidity crises include among others the European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (EFSM). Both are temporary in nature (3 years). In terms of an efficient future crisis management framework one has to ask what follows after the EFSF and the EFSM expire in 3 years time. In this vein, this briefing paper addresses the question of the political and economic medium- to long-term consequences of the recent decisions. Moreover, we assess what needs to be done using this window of opportunity of the coming 3 years. Which institutions need to be formalized, into what format, in order to achieve a coherent whole structure? This briefing paper presents and evaluates alternatives as regards the on-going debate on establishing permanent instruments to support the stability of the euro. Among them are the enhancement of the effectiveness of the Stability and Growth Pact combined with the introduction of a "European semester" and a macroeconomic surveillance and crisis mechanism, fiscal limits hard-coded into each country's legislation in the form of automatic, binding and unchangeable rules and, as the preferred solution, the European Monetary Fund.

JEL codes: E61, E62, F55, P48

Keywords: EU governance, European Financial Stability Facility, European Financial Stabilisation Mechanism, European Monetary Fund, policy coordination, Stability and Growth Pact

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1. INTRODUCTION

One of the most pressing issues these days in Europe is to establish a robust and credible excessive debt prevention and resolution mechanism for the euro area. The recent EU Commission Communication COM(2010) 250 final on "Reinforcing economic policy coordination" states that "a clear and credible set of procedures for the provision of financial support to euro-area Member States (MS) in serious financial distress is necessary to preserve the financial stability of the euro area in the medium and long term." (European Commission 2010a).

The current instruments in the EU to deal with debt and liquidity crises include the European Financial Stability Facility (EFSF), the European Financial Stabilisation Mechanism (EFSM), the European balance of payments instrument and the European macro financial assistance instrument. Out of these, the EFSF and the EFSM are temporary in nature (3 years), and the other instruments do not apply for all EU member states (MS), but only non-euro area MS. In terms of an efficient future crisis management framework one has to ask what follows after the EFSF and the EFSM expire in 3 years time. What will be the adequate modes of governance following the rescue package in terms of institutions and decision making?

In this vein, this briefing paper addresses the question of the political and economic medium-run and long-term consequences of the recent decisions to establish a European Financial Stability Facility and a European Financial Stabilisation Mechanism.

Moreover, we assess what needs to be done using this window of opportunity of the coming 3 years. Which institutions (if any) need to be formalized, into what format, in order to achieve a coherent whole structure? This briefing paper presents and evaluates alternatives as regards the on-going debate on establishing permanent instruments to support the stability of the euro.

What is clear a priori is that any new mechanism should contain clear rules on decision making procedure, funding, conditionality for loans, monitoring as well as resources and powers in order to facilitate borrowing and lending activity in exceptional circumstances and in order to facilitate orderly resolution of sovereign debt and private debt of major financial institutions, if so needed.

2. GOVERNANCE OF THE EURO AREA: BACKGROUND

Where do we stand? Looking at the history of EMU: what are the reference points for deriving the consequences of the recent rescue package and the long-lasting institutional solutions? It seems fair to say that we are still confronted with still unfinished business concerning a sound governance of the euro area. Faced with the “cold turkey” rescue plan launched on May 9/10 this year, investors were impressed for a short time span. European policymakers who have been accused of indecisiveness and timidity had finally made their homework. They wanted to signal that they were in the end capable to agree on new dramatic steps (Annunziata, 2010; Sinn, 2010). Rather soon, however, investors realized that the components of the agreed gigantic rescue package were all directed towards a uniform target: support for the weaker members via a giant stabilization fund and direct ECB sovereign bond purchases (Belke, 2010). At the same time, there was a clear lack of a similarly ambitious decision about how to foster fiscal discipline and to improve cooperation at least in exceptional times. There is overall agreement that the euro area in its current institutional shape has significantly missed the enforcement of fiscal discipline up to the point where some investors and commentators have even expressed their doubt in its survival. The inherent problem appears to be as simple as it is severe: the Stability and Growth Pact (SGP) is found to be time-inconsistent and unenforceable, *not providing any mechanism to override national sovereignty* (Annunziata, 2010; Sinn, 2010).

Since the start of EMU, the official political guideline was to refer to (some say, to praise) the Stability and Growth Pact as the institutional mechanism which is ideally suited to guarantee fiscal discipline and also coordination. But any assessment of the first ten and a half years has to acknowledge that one member country (Greece!) has in the meantime turned to the IMF to avoid bankruptcy, and that the entire euro area appeared and partly still appears (among others Greece but, more recently again, also Ireland!) to be vulnerable to the risk of a systemic debt crisis (Neumann, 2010). Why and how did it all go into the wrong direction? With the benefit of hindsight, it becomes clear that the central flaws in the euro area's institutional setup are both extremely grievous and simple: First, *a currency union cannot work without sufficient fiscal convergence, if there is no high degree of economic integration* (Krugman and Obstfeld, 2009, chapter on "Optimum Currency areas and the European Experience", pp. 565 ff.). Second, the euro area has not been *capable of creating credible incentives for fiscal discipline*. On the contrary, the creation of EMU has lowered and softened the incentives by eliminating the exchange rate risk at the individual country level. At the same time, a perceived "implicit bailout" insurance scheme induced lower credit risk premia and sovereign bond yield spreads. This kind of interest rate convergence based mainly on soft budget constraints is clearly the opposite of what the founding fathers of the euro area had in mind (Annunziata, 2010; Sinn, 2010). Moreover, it is the result of Rating agencies strictly avoiding publishing stand-alone ratings of countries which would rightly exclude the difficult to quantify and politically biased convergence effects of sovereign bailouts. In terms of governance, Rating agencies should be forced to proceed as it is now done in the case of the Deutsche Landesbanken for which the "Gewährträgerhaftung" has been abolished

With an eye on the clear lack of incentives, it did not come as a surprise that fiscal convergence could not be observed up to now and that some countries have come up with running unsustainable fiscal deficits and/or accumulating huge stocks of public debt (both of which they have tend to ignore until recently when most of the countries initiated austerity programmes). In parallel, it proved to be a rational strategy for markets to continuously ignore this lack of convergence. It appeared to them as a safe bet that, if necessary, a member country would be bailed out by its partners. The irony is that since ten and a half years the markets behaved exactly how the ECB expressed they should: they looked at the euro area *as a whole* rather *than at individual* countries – and this specific focus represented an important part of the problem (Neumann, 2010). The convergence of interest rates the SGP targeted at *did* manifest itself de facto in the EMU period until the financial crisis set in – but, as expressed above, for all the wrong driving forces (Annunziata, 2010).

As soon as the irresponsible fiscal policies conducted by some countries perturbed markets, a "passive" fiscal integration, that is the willingness to support the weaker members via substantial transfers – albeit in the form of loans and subject to conditionality – has turned out to be the only way to keep the euro area together as a whole. The *implicit bailout clause* defined above has thus been converted by a toggle switch into an *explicit* one in the form of different variants of rescue packages. Admittedly, member countries are not formally taking over responsibility for one euro area member country's liabilities. Thus, there is no breach of the letter of the Treaty – but its spirit is not upheld mainly because the (chosen at free will) bottom-line of all these measures is that *no euro area member country, no matter how strongly it offends the rules of the game, will be left out in the cold* (Annunziata, 2010; Gros, 2010b). At this point it becomes obvious that the key choice the Task Force under President Hermann Van Rompuy is now faced with is simple but, once met, decisive: should they direct their efforts solely at preventing failure (including *open-ended fiscal support* which might well be the political consequence of installing the EFSF and the EFSM[1]), or should they also prepare for the failure of a member state in order to mitigate the consequences if that should happen?

[1] There is a strong analogy to the argument developed in my previous briefing paper with respect to the ECB bond purchasing programme. With the SMP in place and having bought significant amounts of Greek debt before May 2010, the danger has risen that the ECB will get caught up in the maelstrom of its role of a lender of last resort.

The first choice is bound to imply elaborate measures designed to deliver 'more of the same' – a strengthening of the Stability and Growth Pact, for example, with more provisions for economic policy surveillance and cooperation. So far at least, it seems that most member states (and the EU institutions like the EU Commission and the ECB) are publicly only considering this approach. But this approach does not deliver any answer to the quite fundamental question of what to do if the currently chosen temporary (3 years) framework does not work. As long as EU political leaders are not able to answer that question, financial markets will continue to be unsettled by doubts about the euro's long-run stability (Gros, 2010b). This might exactly be the reason why, for instance, other solutions such as an insolvency mechanism for countries, taking into account an insolvency risk larger than zero, are discussed and played through quite secretly behind the walls of German ministries.

In the following sections we have to keep in mind these lessons learned. To summarize: the euro area cannot stabilise in political and economic terms with a solid framework for crisis resolution being absent and without any capacity to cope with sovereign default by a euro area member state. If one adheres to the view that member states cannot be allowed to fail, this logically implies that one has to argue that a *political union or*, at the minimum, a *fiscal union* must complement the euro. This is the decision which European political leaders and also the European Parliament inevitably has to meet now: either a *drastic step forward towards much more political or fiscal integration*, or a *clear framework to match and to cope with the effects of a member country's failure to obey to the fundamental rules of EMU*. In the latter case, no more integration is necessary, but just the courage of political leaders to publicly admit some failure. No amount of money will allow European leaders to circumvent this issue (Gros, 2010b). It is, thus, important to state at this point that the exact amount of money contained in rescue packages is only of second order importance when assessing the impacts and the success of such a package. Of first order importance is a public commitment by politicians to one of the above mentioned decision alternatives.

3. POLITICAL AND ECONOMIC MEDIUM- AND LONG-TERM CONSEQUENCES OF THE ESFS AND THE EFSM

At the start of the analysis, it appears useful to underline that there are some important analogies between the consequences of the establishment of the EFSF and the EFSM and the effects of the SMP (Belke, 2010, Section 6: "Efficiency of bond market purchases"). I argued in my previous briefing paper that around May 9/10 this year *markets* might *not necessarily have behaved in an irrational manner*. In contrast, their fear not to get their money back was overall realistic. What is more, it could not be taken for granted that both the huge spread increases and the drying out of markets are really "dysfunctional" phenomena or - in view of the fact that Greece's and also Portugal's domestic savings are so small that they are not capable anymore to keep their capital stock constant and to finance their public deficits - "functional" (Belke, 2010). With the benefit of hindsight and looking at the development of sovereign bond spreads after the implementation of the huge rescue package, I feel legitimized to state that this informed guess and minority view has been clearly corroborated in the meantime.

Admittedly, the establishment of the ESFS and the EFSM *buys limited time* for more systematic action - in much the same way as the SMP. However, again in the same way as the SMP, it introduces an *element of subsidy* which tends to severely weaken the fiscal discipline of euro area member countries. The interest rate premium on bonds of fiscally weaker countries *is intended to* decline and the premium for stronger countries *is intended to* increase as soon as bad weather is returning in the form of drawbacks in the recovery process in Ireland or Greece. If the installment of the ESFS and the EFSM is successful,

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The more bonds the ECB will buy, the more difficult it will be to deny further sovereign financing in the future because doubts on the markets will prevail until an institutional solution of debt restructuring will be installed as a *fiscal agent* to be financed by the governments themselves and not through the creation of money (see Belke, 2010).

fiscally *solid* countries would be *punished* and the *less solid* ones, in turn, would be *rewarded* for their lack of fiscal discipline and excess private *and* public consumption. The credit *risk* would thus just *rolled over* from the bonds of the weaker countries to those of the stronger ones *if* the window of opportunity would not be used for credible consolidation in the weaker countries and sovereign default is a probable issue.

It is no contradiction that, according to recent evidence, Germany has even gained in the short run in terms of its bond returns vis-à-vis, for instance, Ireland - as long as the rescue package does not have a too high probability to be activated. This is again a further piece of evidence in favor of the view that bond markets are not dysfunctional and because they again clearly differentiate between specific country risks. However, the current scenario is a quite fragile construction because if the emergency case occurs, things might quickly change and markets will anticipate Germany's high financial burden within the rescue package. So everything hinges now on the *credibility of budget consolidation* in the weaker countries which is quite difficult to assess not least because not every country has aimed at the most promising consolidation mix in times of near bankruptcy – consisting of roughly two thirds of expenditure cuts and one third of tax increases (Alesina and Ardagna, 2009).

Effects of the rescue packages have to be assessed against the facts that, currently, the previously booming PIGS are caught in a deep economic crisis and that Europe is currently struggling to arrive at a new equilibrium in accordance with the new real constellation of country risks. The most important aspect of the temporary rescue packages then is that *they impact on the speed of equilibrium reversion* since they tend to slow down the speed and potentially also *diminish the scope of short- to medium run sovereign bond yield differentiation* in the euro area. This observation has to be attuned with a second, probably dominating one.

That is, the crisis will also have *long-term* implications for the euro area since *budget constraints* in the previously booming PIGS will be *tightened* for many years. Budget constraints tend to become tighter because capital flows out of these countries since the assessment of country risk by investors has altered fundamentally. "Investing funds in Greek state bonds, the Spanish construction industry or US mortgage backed securities is no longer seen as attractive, since the fear of default dwarfs all promised returns" (Sinn, 2010, pp. 18f.).

According to the data, investors have dissociated themselves from their previously prevailing view that country risks only consist of exchange rate risks. The common fears that the former "Southern" weak currency countries eroded their national debt by an inflation-cum-devaluation policy have thus simply been substituted by the possibility of private and sovereign debt defaults (Sinn, 2010, for the relation between devaluation and debt default policies see Burda and Wyplosz, 2009, p. 343).

Markets now anticipate a category of events they had previously reckoned to be not realistic at all. Thus, they claim compensation for the perceived risk by means of interest premiums. As mentioned above, for instance, a closer inspection of the pattern of the euro area country sovereign bond yield spreads (or, equivalently, of most other investment categories) vis-à-vis Germany supports this view. In the first few days after the rescue measures the spreads declined somewhat just in order to increase again afterwards, potentially due to a lack of credibility of the rescue measures limited to three years and the lack of agreement of the French-German axis. In other words, the markets anticipate that the packages do not address some of the key underlying issues.

In principle this can be considered to represent a *beneficial correction measure* of markets which curbs the overheating of the capital importing PIGS as a result of too soft private and public debt constraints. Quite *independent of the political decision-making process*, the market is now enforcing the necessary debt discipline and putting an end to the regime of soft budget constraints which was pervading the euro area (Sinn, 2010). If this is true, the economic effects of the ESFS and the ESFM have to be evaluated also with respect to their low effectiveness. At any rate, the interest rate data clearly support the view that the rescue measures currently do not seem to have the potential to stop the self-correction

process initiated by the markets. Already a month after the agreement on the ESFS and the ESFM the bond yield spreads surpassed their levels prevailing before. What is more, they are currently still on a much higher level than before the outbreak of the EU debt crisis (Sinn, 2010).

Regarding political consequences, one may ask what the reactions of EU leaders will be to the intriguing fact that *the political decision-making process* is probably not involved in the long-run problem solution to soft sovereign budget constraints - as long as no exit of a member country is foreseen (=first political consequence).

The rescue measures as of May 2010 have reduced the risk of country defaults for a maximum duration of three years and were essentially designed to diminish the interest spreads. Exactly by this mechanism, the rescue package potentially *re-establishes the prior capital flows* and thus *unnecessarily extend the high growth period* in the PIGS, because they subsidize the capital invested there by means of *socializing the risk of default* (=first economic consequence). "(T)hey ultimately entail a softening of budget constraints and promise little good for Europe" (Sinn, 2010).

A second order economic problem would consist of a further initialization of capital flows which already were excessive before. Projects with an inferior marginal rate of return would continuously be financed which would – according to standard growth models - lower growth of aggregate GDP in Europe (=second economic consequence). In the worst case, the default risk would become even larger due to worse growth prospects, with potential contagion of all euro area member countries (Sinn, 2010). A default of the major European countries would then have unpredictable effects on the political stability of Europe (=second political consequence). As stated above, increasing bond spreads in the euro area could well be interpreted as an early warning sign that markets did not really trust the rescue packages.

Just to summarize: the good news contained in the above analysis is that market-led equilibrium reversion (i.e. convergence) without political intervention might probably generate a more balanced growth pattern in the euro area, smoothing out the external imbalances within the euro area. (Belke and Schnabl, 2010). An increase in prices and wages will reduce, for instance, Germany's competitiveness and foreign account surplus (Gros, 2010a). This macroeconomic result exactly corresponds with the vigorous demands of French officials like Mrs. Lagarde. However, this pattern is produced in an *endogenous fashion* rather than exogenously by means of government-led wage negotiations – as a consequence of the redirection of capital/savings flows and the induced economic boom (Gros, 2010a; Sinn, 2010). However, this process may take time, something in between a complete business cycle and a decade, because some restructuring of the labor force is involved. For instance, within the PIGS, labor has to move from the non-tradable to the tradables sector which might lead to some political resistance.

4. NEW MODES OF GOVERNANCE? PROPOSALS BY THE COMMISSION, THE ECB, GERMANY AND FRANCE

New institutions and/or modes of decision-making? Some basics

The previous sections have made clear that the EU and the EMU are in dire need of a model of economic policy management that, on the one hand, delivers more than the hitherto implemented fiscal coordination (defined within an interval of government modes ranging from hardening the SGP to the explicit creation of institutions like a however defined European Economic Government as a counterweight against the ECB) and the latest ad-hoc responses to the crisis and, on the other hand, takes into account that any solution cannot circumvent market forces but has to live with them (see section 3, first political consequence). Many political and economic actors label this kind of management *economic governance*. in terms of institutions and decision-making as modes of governance. What it actually means in EU institution circles is a more effective management of national fiscal

policies, the monitoring and correction of negative macroeconomic developments like the lack of convergence in growth and a permanent crisis mechanism (Heinen, 2010).

The Council of European Heads of State or Government agreed on so-called *first orientations* regarding economic governance on June 17, 2010. With respect to the area of *fiscal policy* the effectiveness of the medium-term objectives (MTOs) of the preventive arm of the SGP has to be enhanced – for instance by employing sanctions, national budget rules and medium-term budget planning by EU member states. Government debt – both its level and its trend – is demanded to play a bigger role in the SGP than previously. In addition, *stability programmes* for euro area countries and *convergence programmes* for non-euro area countries shall be developed and presented in the spring of the year before their adoption ("European semester") from 2011 onwards. The aim is to reach better coordination and to arrive at timely action in case of negative developments which have to be corrected. Quite important in view of the Greek case, independent statistical authorities have to assure the quality of statistical data. In the agreements on *stricter macroeconomic surveillance* the application of a scoreboard for an assessment of the trends in competitiveness and macroeconomic imbalances and identifying negative developments in a timely fashion is specified (Heinen, 2010).

Ideas for joint economic governance are currently also in the process of discussion in the Task force headed by Mr. van Rompuy. Publication of the first proposals for the future management of economic policy in the EU and EMU is due in early October this year. Unfortunately, the comments of individual countries on the works of the Task force are not available for the public. However, *position papers* have been published by the *EU Commission* (May 12 and June 30), the *European Central Bank* (June 10) and the *finance ministers of Germany and France* (July 21) with proposals for European economic governance (Bundesministerium der Finanzen, 2010; European Commission, 2010a; ECB, 2010a).

There are some summaries of the different position papers around. In this briefing notepaper, I have chosen to closely stick to the excellent summaries by Bini Smaghi (2010) and, above all, by Heinen (2010). The position papers contain both proposals for *effective coordination of fiscal policy and macroeconomic surveillance* as well as proposals for *future crisis mechanisms* coined for the EU and the euro area. The proposals of new modes of governance in terms of institutions and decision-making do share similarities, but there are also remarkable differences among them. Their most striking similarity is that - as a decision leading the way according to section 2 - they direct their efforts solely at preventing failure instead of preparing for the failure of a member state in order to mitigate the consequences if that should happen. Actually, this appears to be quite hazardous with an eye on the nearly unchanged macroeconomic problems of Greece, Portugal, Spain and Ireland where the credibility and sustainability of the successfully implemented austerity measures has still to be proven. What is more, as long as no member country is granted to go insolvent (maybe because it is argued that financial markets cannot absorb the losses), the euro area can continue to exist only if all its members act in a cooperative and no reckless manner. Gros and Mayer (2010b) correctly argue that experience has shown that this cannot be taken for granted.

The position papers: institutional alternatives to support the stability of the euro?

The *preventive arm* of the SGP is intended to enable more extensive intervention in national budgetary policy in the future, with a stronger focus, among others, on the sustainability of government debt and the condition that national budgets must be run compatibly with the SGP. Sanctions proposed by the Commission and the German and French finance ministries consist of the lodging of interest-bearing deposits by member states not complying with the medium-term objectives of the preventive arm. The ECB has not issued concrete proposals for sanctions, but has done so for surveillance mechanisms. It proposes the introduction of an independent fiscal agency to conduct permanent surveillance (Heinen, 2010).

With respect to the *corrective arm* there is a discussion going on about speeding up the excessive deficit procedure (EDP), and imposing quasi-automatic sanctions together with a reversal of voting arrangements. The latter implies that EU Commission proposals would then have to be rejected by a qualified majority of the Council. It is important to note that at present they must be approved. This last proposal which refers to a new mode of governance in terms of decision-making stems from the ECB and reaches further than the provision originally agreed by the European Council. This means there is no prospect of its implementation for the time being, because it would potentially presuppose an amendment of the Treaty (Heinen, 2010). Moreover, its democratic legitimacy is at stake and should be discussed more deeply.

The final recommendation made by the Commission and the Franco-German duo is the introduction of a *European semester*. This semester is intended to present a phase in the first six months of each year during which the national budgetary policies and the economic policies of member states for the following year are coordinated. With respect to this issue, the ECB has not issued any proposals.

A common feature of all *macroeconomic coordination* proposals is that they propose an installment of an early warning system accompanied by intervention measures administrated by the EU Commission. However, the individual proposals come up with different indicators and different types and prospective severity of the sanctions. As expected, the strictest stance has been taken by the ECB. It proposes sanctions which are modeled on the EDP. Closely connected with this, Heinen (2010) points to an interesting Franco-German proposal to enter into a political arrangement when voting is being conducted to achieve a de facto denial of voting rights. Here, decision-making as a mode of governance is touched upon. This proposal would not require a Treaty amendment and, thus, serves the principle of democratic legitimacy.

Finally, a *crisis mechanism* is throughout all proposals proposed for countries in serious difficulties. All the parties and institutions involved in these proposals agreed that this mechanism can only be set in action under strict conditionality to minimise the risk of moral hazard. The ECB also published proposals regarding the establishment of a euro area crisis management institution, which would have many of the features of the European Financial Stability Facility (Constâncio, 2010). Also and especially from the ECB's perspective, it is crucial to *minimize the risk of moral hazard*, which is always implicit in any ex ante rescue mechanism and might impact on medium-run expectations of inflation. Strong conditionality – reproducing the EU/IMF financial support to Greece – and graded sanctions in case of non-compliance with conditionality, escalating to a de facto loss of fiscal autonomy as the extreme form of sanction, would be institutional safeguards (Constâncio, 2010). While the Commission's proposals emphasize solutions and compliance with certain conditions, the ECB's focus is more on sanctions. This is tougher but could hold even greater potential for conflict. Currently, however, this does not present an acute problem as the existing crisis mechanism (EFSF) did by time and will not need to be replaced until 2013 (Heinen, 2010).

Some of the ideas set out in the Commission's recent Communication on enhancing economic policy coordination for growth and jobs (30 June) are *close to the ECB's proposals* (EU Commission, 2010b). However, for instance, Constâncio (2010) argues that the ECB's proposals are somewhat *more ambitious* because they "feel that the situation requires a quantum leap forward in strengthening the foundations of EMU and moving towards a deeper economic union" (see also Bini Smaghi, 2010).

The position paper proposals – an assessment

Taking the *first orientations* as a starting point for an assessment of the different position papers it makes much sense to differentiate between economic governance in *fiscal policy* and in *macroeconomic surveillance*. Heinen (2010) presents an excellent and as compact as possible synopsis of the position papers and also gives a short but appropriate assessment of the proposals contained in terms of three realizations of grades (+ = commendable, 0 = ambivalent/imprecise and - = inadequate). This could not have been done better and,

hence, I advise the reader to consult this source for more detailed information. The main result is that the European Commission and also the ECB and the German and French finance ministers have produced *very clear papers* which, unfortunately, give not too much reason for optimism – in view of the large number of zeros in the evaluation scheme by Heinen (2010). Their analysis of the key underlying problems is extremely lucid and focused - the recommendations, however, suggest according to the view of Annunziata (2010) and others that we are *about to repeat the same mistakes of the past again*.

There is the suggestion of the Commission to introduce a *more comprehensive framework of ex-ante policy coordination*, with a "European Semester" where it would examine the individual countries' budget plans and then issue recommendations for corrective action based not only on each country's fiscal trajectory, but also on the aggregate implications of the individual plans. This framework aims at keeping individual countries to their fiscal targets and at avoiding persistent and large intra-euro area imbalances. (Belke and Schnabl, 2010). But it is left open what could actually force countries to change their budget plans according to the Commission's recommendations in times of conflict. The Commission also suggests that countries exceeding the SGP deficit ceilings should be forced to set aside funds in interest bearing deposits. But again: "what makes us think that these interest bearing deposits would be enforced, when the fines already envisaged in the SGP have never been levied" (Annunziata, 2010)? Commission proposals would then have to be rejected by a qualified majority of the Council. But in scenarios like the current one in which the qualified majority of member countries have preferences which go beyond the notion of EU economic governance as a mere hardening of the SGP, credible enforcement of budget discipline might become a difficult task even in good times.

The simple but obvious and central problem inherent in both the old and the proposed "new and improved" SGP is that *none of them disposes of any mechanism to override national sovereignty*. Taxing and spending decisions rightly rest with the elected representatives of each individual country - and since there seems to be no appetite for full political union at least in the former hard currency countries (Annunziata, 2010, Neumann, 2010), this is quite safely not going to change.

5. THREE POSSIBLE ALTERNATIVES

Expulsion of a country from the euro area

There are then only *three possible ways* of setting the right incentives for fiscal discipline remaining. The *first* would be for the euro area to use the only credible threat available to any club: to *revoke membership*. The treaties could in principle be amended to specify conditions under which a country would be automatically expelled from the euro area (Neumann, 2010, for a diametrically opposed position see Bini Smaghi, 2010). However, this might have the drawback that it resembles a too "Germano-centric" solution and, thus, might not be shared by the majority of countries.

What is more, some argue that there are at least two serious flaws in this idea (see, for instance, Annunziata, 2010). The first caveat is that the punishment might be "too harsh to be credible": expelling a country from the euro area would have serious impacts on the sinner and dramatic spillover effects on the remaining members. The second is that it would provide an ideal setting for speculation, the very nemesis of European politicians. A country approaching the conditions for expulsion would quickly find itself under immense market pressure, as some investors would bet on its inability to redress the situation and others would need to hedge themselves against the potential consequences of it being kicked out (Annunziata, 2010). As argued, for instance, by many French colleagues, this is equal to throw away the very idea of a currency area of a permanent institution.

One could argue that this kind of argument misses the point because the fundamentals of Spain and Italy, especially in their self-financing capacities, appear much stronger than those of, for instance, Greece and Portugal. And this in itself speaks against contagion proving fatal. Moreover, it can be argued that neither Spain nor Italy would gain much from

a default since most of their public debt is held by their own citizens. A default would thus not lower the foreign debt of the country (Gros, 2010c). The litmus test for the euro area is thus not whether it is able to save a country like Greece, but instead whether it can protect members from speculative attacks which do not suffer from any insolvency problem (Gros, 2010c).

Implementation of a European Monetary Fund

Taking these considerations into account, a second solution would be the immediate *installment of any sovereign default* mechanism such as a European Monetary Fund, i.e. the conversion of the starting capital provided by the European Stabilisation Mechanism which currently is not more than a Special Purpose Vehicle (SPV) into a European Monetary Fund (EMF) which will be discussed more deeply in section 6 below.

Hard-coded national fiscal limits

A third potential solution would be to "hard-code" fiscal limits into each country's legislation by means of automatic, binding and unchangeable rules. Annunziata (2010), for instance, advises euro area policymakers to adopt the Polish procedure which lets the Constitution set a public debt ceiling. As soon as the limit is passed, it enforces automatic budget adjustment. In the euro area with too many countries already substantially exceeding the 60% debt to GDP threshold *imposing a constitutional limit to the budget deficit* would be part of the solution, with a rule imposing a specific percentage reduction in budget expenditures whenever the deficit exceeds 3% of GDP, and progressively deeper cuts if it breaches higher percentage shares of GDP. The government would be still endowed with discretion over the composition of spending, but would be forced to diminish the overall level of it. Obviously, Annunziata (2010) has Germany in mind as a blueprint which has already unilaterally adopted For a more drastic version of this, the "debt brake".

One caveat emerging in the detailed discussion *of this proposal is that it would provoke "political cycles" in which* a party approaching the end of its electoral term and suffering from low popularity, i.e. a "lame duck", feels inclined to increase the budget deficit with the aim to tie the successor's hands. The latter would then be forced to conduct politically unpopular austerity measures. However, such political budget cycles are already now part of everyday political life. The underlying budget rule would also not provide any automatic allowance for cyclical fluctuations of GDP growth. This might appear to some as an unusually strict limitation, but, as argued by Annunziata (2010) and others this pays for clarity and simplicity in this case. Imposing a limit on the cyclically adjusted balance would imply that the mechanism would be dependent on the difficult to measure and often ex post revised potential growth. "It would be much better to leave to the governments the responsibility of running a tighter ship in good times to limit the risk of slippage during recessions" (Annunziata, 2010).

The proposed rule would still enable a large enough fiscal reaction to a bold negative demand shock, as observed in the first two quarters of 2009. The rule would provide that the response is restricted to one year, automatically unleashing a correction in next year's budget. As we have just experienced with the PIGS, after a significant abrupt worsening of the fiscal stance an immediate correction is already enforced by market action. Sticking to the rule with a one-year escape clause would enable the eurozone to undergo the same adjustment while investor confidence remains well supported. This would be preferable (Annunziata, 2010).

Every euro area member country should be obliged to implement this clause in its own constitution as a condition-sine-qua-non for uninterrupted membership. As a further provision, Annunziata (2010) proposes that *any deletion or amendment of this clause later on should lead to an automatic exit by the respective country from the euro area.* Striving to find any mechanism to override national sovereignty is not necessary anymore, since each national legal framework would automatically preserve the common fiscal rules. By obeying the bottom-up, i.e., subsidiarity, decision pattern his would clearly serve the *principle of democratic legitimacy*. "It is hard to force a country to follow the policy dictates

of its neighbor - but it should be much less controversial to argue that all members of the club should pledge allegiance to the commonly agreed rules in a fully binding way" (Annunziata, 2010).

Admittedly, such kind of a solution turns out to be *politically rather demanding*. But authors like Annunziata (2010) correctly state that at the same time the challenges we face are severe enough to justify politically mettlesome decisions. The euro area with its current institutional framework has sown the seeds of a larger moral hazard problem which – as we have seen in section 3 - will not be made obsolete by the conditionality connected with EU loans. One option for countries to cope with this problem, is to really internalize the euro area's common objectives. As Annunziata (2010) puts it: "Requiring countries to amend their constitution sets the bar high - but it is the kind of step that would demonstrate near-irrevocable commitment to fiscal discipline, and the dividends in terms of credibility would be enormous".

*In this sense, it would simply be a waste of time to continue the botch job with a SGP which has to be regarded as unenforceable (*because it can never over-ride national sovereignty*) and time inconsistent (*because when the time to tighten policy comes, countries have no incentive to do so). At this point, the euro area member countries should credibly commit to serious fiscal responsibility and should see this as the price to pay for remaining in or acceding to the euro area. This commitment could be made binding and effective by embedding the common fiscal rules within national legislation (Annunziata, 2010).

This institutional solution would of course not directly tackle the remaining larger problem depressing the euro area and is hampering convergence, i.e. the lack of progress in structural reforms. (Belke and Schnabl, 2010). However, imposing binding limits on fiscal deficits would indirectly reinforce the governments' reform incentives since higher growth rates would render fiscal adjustment less painful (faster "crowding-in of reforms").

A postscript to the proposals in the position papers

With regard to economic policy, the issue of *different proposals for euro area and non-euro area countries* will probably come onto the agenda sooner or later. Such a differentiation is conducted in the position papers published by the Commission and by the Franco-German finance ministers. They stress sanctions and conditionality to a lesser extent for non-euro area countries. Whereas leaving room for convergence might be a plausible first glance argument in favour of this unequal treatment, the question looming on the horizon is whether and by how much an economic "core Europe" could decouple itself from the non-euro area countries and, by this, indirectly lower their probability to enter the euro area in the future (Heinen, 2010).

The European semester has the potential to be extensively discussed by EU leaders. Thereby, the treatment and integration of national parliaments disposing of budgetary prerogatives will continue to represent a critical issue. As experience shows, the national parliaments tend to insist on exercising their rights which makes a European peer review of draft budgets prior to the national budget process an event of low probability in the near future. This creates a constitutional problem which could not be solved by integrating the European Parliament. These problems notwithstanding, the European semester would even be useful for an effective coordination by means of the exchange of information and creating transparency of information flows (Heinen, 2010).

Finally, it will be interesting to see whether and by how much market expectations would be impacted by quasi-automatic sanctions and a reversal of the burden of proof in the EDP. It cannot be excluded that in this case the triggering of the EDP could cause significant reactions by the markets. On the other hand, such a change in processes of this kind – just like the European semester – would be a clear sign of a paradigm shift towards more serious budget coordination that could be rewarded by the markets (Heinen, 2010).

All three documents, the position papers by the EU Commission, the ECB and the French-German one, refer to the objectives of the Europe 2020 growth agenda. On the one hand,

this might give reason for some commentators to hope that this growth agenda may be more successful than the previous one (Heinen, 2010). On the other hand, it may only serve to contribute to "Europe's competitiveness obsession", a notion coined by Gros (2010a). He asks whether higher productivity is leading to higher competitiveness and, thus, really the way out from intra-euro area divergences. He alludes to the fact that, across the EU, even the opposite is true in many cases. For instance, Ireland which benefitted from the highest growth in labor productivity at the same time got rid of the most competitiveness. This is because improvements in productivity are easily overwhelmed by changes in wages.

The last part of the puzzle is to solve the central question of what determines wages? There is ample evidence that, in the last ten years, the largest wage increases took place in countries like Spain or Greece which experienced the strongest domestic demand growth. This lets one to conclude that demand is driving wages and not the other way round, since the PIGS suffered from the bulk of the loss of competitiveness *after* unemployment in these countries had fallen sharply. The statistical loss of competitiveness of the PIGS thus should not be traced back to a too low degree of reforms or too aggressive trade unions, but instead to booms in domestic demand. The latter has been driven above all by cheap credit for consumption purposes in the case of Greece and for construction work in the cases of Spain and Ireland. This, in turn, translated into higher labor demand and, as a consequence, also to higher wages there (Gros, 2010a).

If excessive domestic demand in the PIGS was the problem, *the solution to intra-euro area asymmetries should now be approaching.* This represents just the other side of the coin of the purely market-driven equilibrating process identified in section 3. In this section we have shown that international investors already have curtailed credit to the PIGS. The bold austerity programmes recently launched in these countries should contribute further to lower growth rates of or, in some cases, even a sharp decrease in domestic demand there. If labor markets are flexible, this should result in lower wages. Indeed, that is the key condition: labor-market flexibility on the way down as much as on the way up (Gros, 2010a).

Seen on the whole, thus, "the proposition that governments 'must do something about competitiveness' risks leading to an *excessively activist approach to economic policy coordination*, with governments and EU institutions constantly trying to influence wage-setting in the private sector" (Gros, 2010a). This activist approach has the potential to work at least partially in the current crisis scenario. However, if domestic demand starts to diverge again, the same activist approach will not be able to prevent future divergences in competitiveness. Enacting structural reforms always deserves attention and proves to be useful in many cases. However, fostering productivity takes years and there is no guarantee that it really feeds into higher competitiveness. Instead, the Southern European member countries must accept that domestic demand has to fall to a level which makes countries independent of protracted inflows of foreign capital (Gros, 2010a). Once this threshold is taken, it should be enough to give labor markets sufficient leeway to approach and to settle down at its new equilibrium. Again, this is a clear corollary to our analysis in section 3 which is heavily related to capital instead of labor markets.

Conclusions

At the time of writing this paper, it is much too early to check whether the work of the Task force will actually endow the EU and EMU with robust convergence enhancing measures in times of larger uncertainty than usual. The outlook appears mixed, if the proposals made by the van Rompuy Task force are based on the recently published orientations and position papers and not on the three alternatives presented in this section. Their main problem is that they are based on the fiction that the euro area is not admitted to lose a single member. The proposal of a European Monetary Fund is intended to get rid of the latter fiction but at the same time tries to be as market and incentive compatible as possible.

6. THE EUROPEAN MONETARY FUND – MORE PROS THAN CONS

Some say that talking loudly about an EMF is not more than "smoke and mirrors". According to this view, in spring 2010, Germany's finance minister Schäuble who temporarily was supporting the idea of an EMF publicly said to be keen to be seen to do something for Greece, without spending any money (Economist, 2010c). But I think that there is more in it. Gros and Mayer (2010a) argue quite convincingly that setting up an EMF to deal with Euro area member countries in financial difficulties is superior to the option of either calling in the IMF or muddling through on the basis of ad hoc decisions. With respect to its financing mechanism, conditionality, enforcement and the orderly default mechanism involving creditors as well, it does entail *more limitations to moral hazard* than other proposals but of course cannot completely get rid of it (see section 2). Daniel Gros and Thomas Mayer have suggested that this fund operates as an insurance scheme based not on euro area country premiums, because the very existence of the EMF itself depresses CDS spreads and yield differentials within the euro area, but on the compliance of euro area countries with the Maastricht deficit and debt levels (Gros and Mayer, 2010a, p. 3). The less disciplined a country is in budgetary matters, the more it would pay in. This might work much like an efficient preventive arm of the SGP would.

Moreover, the recent position paper by the ECB as of June 10 comes up with quite similar positions without referring explicitly to the EMF. Most strikingly, the ECB proposals might also necessitate Treaty changes – in the same way as the EMF does. This property, however, was used, for instance, by Mrs. Merkel as a K.O. criterion against the EMF (New York Times, 2010). Actually, it is a subject of considerable debate whether you would need a Treaty change to create an EMF or not. Up to now one can even think of a legal opinion, saying you do not need to touch the treaties to create such a fund, and that a unanimous decision of the 27 heads of state and government would do. But also in this case you may ask what is wrong with installing an IMF when the ECB comes up with a rather similar proposal and there is not even the need of a Treaty change.

So it is interesting to see what the position of the German government will finally be with respect to the ECB proposals. Without a clear framework, decisions about how to organise financial support typically have to be taken hurriedly, under extreme time pressure, and often during a weekend when the turmoil in financial markets has become unbearable.

The proposal by Gros and Mayer (2010a) is not meant to constitute a 'quick fix' for a specific case. Greece is the problem today, but it will not go away quickly. The experience of Argentina shows that default arises only after a period of several years in which economic and political difficulties interact and reinforce each other. Failure is not inevitable, as the relatively successful experience so far with tough adjustment programmes in Ireland and Latvia are showing. But what is unavoidable is a considerable period of uncertainty. With an EMF, the EU would be much better prepared to face these difficult times.

But some countries, political leaders and even the ECB have resisted the idea, raising concerns about having to bailout other EU countries due to their own reckless financial behaviour. Others wonder whether an EMF is repetitive, needlessly overlapping with the function of the IMF. These and other arguments are presented below.

There are several arguments in favour of the view that *installing an EMF is necessary beyond the role of the International Monetary Fund.* In the first place, a European Monetary Fund creates a *global and* a regional system (Johnson, 2010). Other IMF-like regional funds which have been created outside the euro might serve as the blueprint for it (EU Business, 2010). This would also deliver more symmetry in the distribution of funds worldwide. Another advantage is that installing a European Monetary Fund avoids 'foreign' IMF intervention – which might be strategically important in times of the euro area struggling for more impact in international organizations like the IMF or the G-20 (EU Business, 2010). Any IMF bailout would undermine the EU's legitimacy. This has nothing to do with humiliating the EU and the "European pride" (Economist, 2010a).

As expressed by the German finance minister, the EU needs a European Monetary Fund with equal power as the IMF for the internal stability of the euro area (BBC, 2010). Moreover, the EMF is specially designed for the Euro Bloc, whereas the IMF was not designed for developed Euro countries (New Europe, 2010). Seen on the whole, thus, installing an EMF is neither only just re-inventing the wheel with an already existing suitable tool, the IMF, nor is a potential EMF which can dispose of the SPV billions of funds not big enough to save entire EU countries. It does also not seem to be the case that the IMF has true neutral bargaining power. Even without relying on a sometimes doubtful US-bashing saying that the IMF is US-dominated and also follows strategic interests in supporting countries more leniently which grant the location of US military bases like, for instance, Greece, two facts stand out: 1) During the negotiations with Greece on the conditionality of the rescue package, the IMF proved to be definitely less hardnosed than its two European counterparts of the "Troika". 2) One could even be forgiven for thinking that there is only limited US interest in the stability success of the euro area because this would eventually mean the loss of the reserve currency in the long run (Belke and Schnabl, 2009).

In terms of efficacy, *the EMF would be able to deal with crises effectively*. The EMF would improve EU fiscal federalism/coherence without incurring much of a moral hazard (Thoma, 2010) and, even more important would *allow orderly sovereign default*. It could impose tougher sanctions than the IMF (New York Times, 2010). The EMF could also *enhance the transparency of public finances*, because its intervention mechanism in the case of failure would penalise all derivatives and other transactions that had not been previously registered with a special registry of public debt, which the EMF would maintain (Gros and Mayer, 2010a, pp. 4f.). Just to state that the EMF is not a short-term solution to immediate crisis does not make sense any more since the emergency measures already taken have opened a window of opportunity to install a long-run mechanism. Moreover, the argument that it is not helpful to talk about ways to institutionalize help when the question is how to implement the budget reforms cannot serve as a guiding line if the EMF is superior to just hardening existing budget restrictions like the SGP (Saltmarsh, 2010)

The installment of an EMF is feasible because it could be financed effectively and would work much like the effective IMF which stopped enormous bankruptcies to ensure the world economy's safety. The only difference is that the EMF's protection would only reach to Europe (Economist, 2010b).

A simple funding mechanism would in normal times or in the long-run also *limit the moral hazard* that potentially results from the creation of the fund (Economist, 2010b). Only those countries in breach of set limits on governments' debt stocks and annual deficits would have to contribute, giving them an incentive to keep their finances in order. This is exactly the reason why it cannot be claimed that the European Monetary Fund would encourage fiscal irresponsibility.

Concerning *non-normal times*, however, the EMF suffers from a drawback which is inherent in some other solutions such as the IMF solution and the EFSF and its Special Purpose Vehicle. This drawback has, for example, been addressed by Perotti (2010) who argues referring to the Gros and Mayer proposal that: "(B)y the authors' calculations this facility would today give Greece access to something like .65 percent of its GDP ... plus any additional discretionary fund from the pool of all accumulated savings. However, .65 percent of GDP would make no difference to Greece today; and ... the intervention needed would eat up the whole fund just for a small country like Greece. The key problem country, Spain, with a public debt just above the Maastricht level this year, would have made virtually no contribution to the EMF. In the end, effective intervention, especially when the risk of contagion is high, is likely to depend on the discretion of Germany and other non-problem countries, just as it does now." Moreover, the availability of financial means should be no problem since, as stated above, the newly created Special Purpose Vehicle could be directly converted into an EMF.

Referring to *public opinion* and to the question where the public stands, the EMF follows two distinct principles. First, *solidarity around EMF would matter more than moral hazard***.**

"Member countries of the EU have signed up to the principle of solidarity, which is enshrined in numerous passages of the Treaty. Hence, they can expect to receive support when faced with extraordinary financing difficulties" (Gros and Mayer, 2010a). And second, *public opinion is considered to be immaterial***.** During financial crises when a member state is on the brink of collapsing, public opinion should matter less than coherent plans to solve the crisis. *The very fact that the EMF is funded proportional to GDP might be unpopular among big states.* However, also alternative institutional solutions such as the hardening of the SGP still rely on budget deficits and debt levels *per GDP*. In any framework of orderly default, creditors should be called on according to their involvement and this is often proportional to their GDP.

This is not to say that there are only pros and no cons of an EMF to be reported here. For instance, one potential drawback of the EMF might be that *if the EMF is more strict in terms of its economic and financial conditions, European countries will go to the IMF*. Moreover but very much like other sovereign funds solutions, the *EMF might siphon off capital and increase national borrowing costs (Gokhale, 2010).* The recent events around a potential Greek default have vividly demonstrated that in the absence of a mechanism to manage an orderly sovereign default, adjustment programmes lack credibility and the balance sheet of the ECB is put at risk by the Securities Markets Programme as shown in detail in my June 2010 briefing paper for the European Parliament (Belke, 2010). *Only sovereign funds reveal the true opportunity costs to the initiators.* However, if one chooses the way through the ECB and the printing press via the SMP, the opportunity costs of adjustment programmes wrongly appear to be close to zero. So, what is the problem in making opportunity costs explicit by increasing borrowing costs? The alternative would anyway, in view of our results, not be a separate hardening of the SGP but, instead, the introduction of something like constitutional national debt brakes or even a return to the paradigm of "let the market mechanism play".

The latter is a solution which is strikingly underrepresented in the wide array of public proposals of instruments to stabilize the euro up now, given specific country interests (Sinn, 2010, section 3). Although all countries have announced broad-based bank rescue packages, investors have *differentiated* between countries mainly on the basis of other, more country-specific factors (e.g., the fiscal outlook). This pattern is usually revealed in a euro area context by a comparison of ten-year government bond yield spreads of euro area countries over Germany and the expected budget balance relative to Germany in a couple of studies mentioned regularly in ECB outlets. This has also been valid more recently, after February 2010 when markets have increasingly differentiated among the weak members. A policy implication of these findings is that market valuation of sovereign risk remains a valid mechanism to discipline fiscal policy especially but not only in times of financial crisis. Therefore, some even argue that there is little justification for the claim that governments faced with high risk premiums during the crisis deserve the solidarity of other governments in the euro area (Schuknecht, von Hagen and Wolswijk, 2010, and the papers cited in Belke, 2010, section 1). As stated above, the EMF does not go as far as this but maintains a conditional solidarity, i.e. countries in financed difficulties are entitled for financial support according to their previous payments and their agreement to tailor-made adjustment programmes supervised by the Commission and the Euro Group.

Another counter-argument to be taken seriously is that *the EMF cannot be set up without a new Treaty*. The creation of the Fund may indeed face many legal impediments (EU Business, 2010). German Chancellor Angela Merkel says EU treaties, which currently forbid euro area countries from coming to the financial rescue of another, must be changed. That could prove laborious in the extreme, going by the years of referendums and special exemptions required to ratify the Lisbon Treaty, which took effect only in December. Countries like France have little appetite for new Treaty negotiations. But as stated before, if this knock out criterion is applicable to the EMF, this should also be the case for the ECB proposal as of June 10. Moreover, as said, the last work does not appear to be spoken about the legal necessity of a Treaty change.

Finally, some argue that *investing EMF assets abroad could cause consternation* (Gokhale, 2010). To ensure a credible commitment to crisis avoidance, the fund should be invested in non-European financial securities. But that would remove investible resources from Europe- this might be something which member nations are unlikely to support. Further research should check the validity of these arguments and, in addition, whether they are relevant for the alternatives to the EMF, too. If the cons are weighted more heavily than the pros and strictly enforcing budgets appears better than creating EMF, the solution must be to go for hard coded *national fiscal limits.*

7. CONCLUSIONS

Though from another angle, the above analysis supports the view that without the immediate installation of any sovereign default mechanism such as a European Monetary Fund, the ECB has to bear the burden. It risks to degenerate towards the *'Bad Bank' of the euro area* as timid investors are offloading sovereign bonds with uncertain repayment values on the ECB's balance sheet. Investors clearly understand anyway that some countries protected by the installment of the ESFS and the EFSM these days will still have the potential to become insolvent.

Recent events have vividly demonstrated that in the absence of a mechanism to manage an orderly sovereign default, adjustment programmes and austerity packages risk to lack credibility and the SMP puts the balance sheet of the ECB at risk. What is more, only sovereign funds reveal the true opportunity costs to the initiators.

Seen on the whole, the most demanding task is to prevent that the euro area has stumbled into a perpetuation of financial rescue packages by the installment of the ESFS and the ESFM. What is difficult to see at the moment is how, once started, it can stop. The preferred way out appears to be the creation of a European Monetary Fund.

The ECB could contribute to sovereign debt consolidation by solely accepting (of course, after a transition period) bonds issued by those countries which have introduced upper bounds to debt levels as collateral. I referred to this proposal already in Belke (2010) as an (maybe inferior) alternative to an immediate installation of a European Monetary Fund. This proposal á la Martin Feldstein appears to be beneficial because imposing "debt brakes" and the resulting decrease in the interest to be paid should be in the national self-interest of the respective countries.

Interest rate convergence within the euro area was also the result of Rating agencies strictly avoiding publishing stand-alone ratings of countries which would rightly exclude the difficult to quantify and politically biased convergence effects of sovereign bailouts. In terms of governance, rating agencies should be forced to proceed as it is now done in the case of the Deutsche Landesbanken for which the "Gewährträgerhaftung" has been abolished.

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