
The Sovereign Debt Crisis in Europe, Save Banks Not States

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Abstract

The European central bank is a bank of banks but not a bank of states. This reduces the capabilities of member states to finance deficits. The role of the central bank to cope with the debt crises is institutionally more limited than in most other Western countries. The European Stability Mechanism has not enough financial power to bail out all distressed countries in the Eurozone. Eurobonds could increase lending capacities but would require a change of the European treaty, which is not in sight. They violate the no bail out clause of Art.125 of the Treaty on the Functioning of the European Union. The policy option is therefore debt restructuring of distressed countries and a bailout of financial institutions to avoid conflagration. This option would also shift some of the burden to creditors outside the Eurozone rather than to shift all risk on the people in solvent countries within the Eurozone.

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1. Why the Euro?

What is the economic rationale for the Euro? Some economists, Paul Krugman the most prominent among them, maintain that there is no rationale at all and view the Euro as a purely political and even romantic project for a disparate economic zone for which a single currency fits like the saddle on the cow². If they are right, the Euro cannot and should not survive and hence the best strategy to end the current crisis would be to reintroduce national currencies. This would allow troubled countries to devalue their currencies and thus regain international competitiveness.

However others, including Barry Eichengreen, one of the most knowledgeable observers of the European Union and its financial architecture think differently. In his article in the *Journal of Economic Literature* Eichengreen maintains that the introduction of the Euro was a consequent move after the establishment of the single European market. The European Union is not just a customs union but also a free market for services, capital and labor. The European treaties, the large body of secondary law and the decisions of the

¹ Professor of Law and Economics at Bucerius Law School in Hamburg. This is the written version of my keynote lecture held at the Italian Society for Law and Economics in Turin in December 2011. I wish to thank Giovanni Ramello, Peter Behrens, Axel Moeller, an anonymous referee and the participants of the conference for valuable comments.

² Paul Krugman, 'Boring Cruel Romantics', *New York Times*, 20 November 2011 "The truth is that Europe's march toward a common currency was, from the beginning, a dubious project on any objective economic analysis".

European Court of Justice have removed even the most remote barriers to the entry of national markets. No other collection of states has achieved this depth of market integration. The downside of this is an inherent vulnerability to sudden exchange rate changes in member countries, which can have major disruptive effects. This consequence of the single European market led to the introduction of the European exchange rate mechanism with almost fixed exchange rates as early as 1979. But with different inflation rates within the EU this mechanism was unstable. In 1992 both Britain and Italy heavily devaluated their currencies. This led to disruptions in the industries of other member states with huge layoffs of workers and a devaluation of the capital stock in export as well as import substituting industries. The consequence of this experience was the decision to take the risk of a common currency, in which such disruptions for investors and workers cannot occur³. Without the Euro it is questionable whether the deep market integration is sustainable. It might have to give way to a form of integration closer to what we have in the GATT/WTO framework. Just to illustrate: In Greece a newly appointed schoolteacher with a University degree currently earns a salary of little less than 1000 Euro per month and 80 per cent of employees in the public sector earn between 1000 and 15000 euros⁴. Assume that Greece would reintroduce the Drachma and devalue it by 50 per cent as analysts forecast for that scenario. The salary would then decline to less than 500 Euro per month. This might lead to massive emigration like in neighboring countries Bulgaria and Romania, or in Poland, which are EU member states but not part of the Euro zone. What would this mean for Greece with a population of 11 million and for its economic and political stability? This is unclear. Emigration causes huge workers remittances, which stabilize the economy as in India, China and Poland⁵. But a sudden wave of migration from Greece to other countries can also cause severe shortages of public services like in the German Democratic Republic before it built the Berlin wall. If for instance medical doctors, teachers and nurses would leave the country suddenly and in large numbers their remittances could not compensate for the negative effects of a decline in the availability of public services. And it is unclear and unlikely that the

³ Eichengreen B. (1993)

⁴ Unlike for most other states, neither the International Labor Organization (ILO), nor Eurostat publish timely statistics on wages and salaries in Greece. The following figures for the year 2011 are from the Bundesagentur für Arbeit (the German Federal Employment Agency). "The highest pre-tax minimum wages, € 1,080 per month, are paid in the financial services industry, and the lowest – about € 683 – in engineering and electrical and electronics industry (as of 2007). An engineer, with up to three years of professional experience, will get on average at least € 1,034 gross per month, a programmer € 702, a secretary with language skills € 717, an accountant € 771 and a driver € 716. www.ba-auslandsvermittlung.de/lang_de/nn_2856/DE/LaenderEU/Griechenland, last visited on 02.25.2012. Translated." www.ba-auslandsvermittlung.de/lang_de/nn_2856/DE/LaenderEU/Griechenland, zuletzt besucht am 25.2.2012

⁵ Ratha D. (2003)

Greek state could impose restrictions on emigration for workers in the public service without violating European law.

2. Elements of the crisis

What explains the current crisis of public debt? I concentrate on the three main factors. First the Lehman crisis, which forced the Eurozone states to increase their public debt by roughly 20 percentage points⁶. Second the legal constitution of the European central bank, which makes it a lender of last resort for banks but not for states. And third the different development of wages in Germany and in southern European states, which have increased German competitiveness and decreased competitiveness in the south.

Without the Lehman crisis public debt in the Eurozone would not be 80 percent as it was in 2010⁷ but only 60 percent of GDP. It would be higher than that in the South, in Portugal and Italy, and much higher in Greece, but much lower in Spain, a country with low budget deficits and even budget surpluses until the Lehman crisis. In Germany the Lehman crisis added 15 percentage points and the costs of the German unification added 20 percentage points to its public debt ratio, which would have been less than 50 percent of its GNP without these two events⁸. The widespread view that the crisis reflects above all the crisis of the Continental European welfare state is clearly wrong. Sure, pork barrel legislation and campaign goodies play a big role in the troubled Eurozone countries. And everywhere in Europe we have the friendly politician, who promises every citizen an income, which is higher than the average income. But I doubt that this is significantly different in the Eurozone as compared to many other Western countries. And this becomes even more obvious, when we look at public debts in other rich countries. For 2011 the public debt estimates for the USA in the USA are 102 percent of GNP, considerably higher than in the Eurozone, 84 percent in the United Kingdom, slightly higher than in the Eurozone and 204 percent in Japan, higher than in any country in the Eurozone including Greece⁹. And none of these countries faces a similar crisis of its public debt as Spain or Italy. Also in historical perspective present public debts are not excessive as the British example tells. The ratio of British public debts to GDP after the Napoleonic wars and after World War II was about 250 per cent¹⁰. And this burden did not lead to

⁶ From 2008 to 2010, public debt in the euro area rose from 66 percent to almost 85 percent of gross domestic product. In the UK, the increase was significantly steeper, from 54 to 84 percent. See Eurostat, gross debts.

⁷ Eurostat (2011)

⁸ Gert G. Wagner (2012)

⁹ USA, The World Factbook, Central Intelligence Agency, www.cia.gov/library/publications/the-world-factbook/rankorder/2186rank.html

¹⁰ UK Public Spending www.ukpublicspending.co.uk/uk_national_debt

state bankruptcy nor did it cripple the British economy but disappeared with time and economic growth.

Why are some countries in the Eurozone in trouble and face high interest rates for their government bonds, whilst at the same time other countries like the USA, Britain and Japan have no problems at all to roll over their debts with interest rates around 2 percent, which in the UK and the USA are presently even slightly lower than for German government bonds? This is a consequence of the legal construction of the European central bank. The legal status of the European central bank does not allow it to signal to creditors that it will buy government bonds with full firepower in case of a liquidity crisis¹¹. In the USA, the UK and Japan as well as in almost all countries worldwide the central bank can act as a lender of last resort to the banks and – directly or indirectly – to the state and can credibly signal this to creditors, as quantitative easing¹² is in principle unlimited. The European central bank cannot give the same signal. It cannot buy government bonds on the primary market and its purchases of bonds on secondary markets are limited. Unlimited quantitative easing would annihilate the legal norm, which prohibits state financing by the ECB. This legal restriction makes creditors nervous and explains the extraordinary interest rates in the troubled countries. Without betraying its legal mission the European Central bank cannot buy bonds of highly indebted countries until a target interest rate is reached. Greece is probably a special case and might have run into insolvency regardless of the institutional form of the ECB. If we had a European central bank, which would lend to the states in the same way as other central banks even at the risk of inflation, the crisis would not have erupted. But given the legal framework every country in the Eurozone is forced to take up Euro credits almost as if they were foreign currency credits. For credits in foreign currency however a state cannot improve its debt servicing capacity with monetary instruments. It needs to increase the real GDP or the tax rate or lower state expenditures. Therefore the possibility/ability to finance the states in the Eurozone with public debt is inherently lower than in other countries. This should have been clear from the outset. The Maastricht criterion of an upper threshold of public debt of 60 percent of the GNP¹³ reflects this. But neither the European Commission nor the states of the Eurozone nor even the creditors

¹¹ Many international observers regret this with George Soros being one of the most prominent: „Member countries share a common currency, but when it comes to sovereign credit they are on their own“: G. Soros, *The ‚Crisis&the Euro‘*. *The New York Review of Books*, 17 August 2010

¹² In February 2012 The Federal Reserve held 1.7 bn. Dollars of US securities, about six times as much as the European Central Bank. See Federal Reserve Statistical Release, February 2012. The central banks in the UK and Japan follow a similar policy to keep interest rates down.

¹³ Article 104c Maastricht Treaty

have taken this criterion seriously because of its weak enforcement mechanism¹⁴. Now debtors as well as creditors learn it the hard way through market forces.

The third reason for the present crisis is only indirectly related to government debt. Since the introduction of the Euro the target inflation rate announced and also realized by the ECB was 2 percent. In Germany it was a bit lower than 2 per cent and in the southern states it was a bit higher than 2 per cent during the whole period. Therefore within 11 years, or more precisely since 1997, when exchange rates became fixed and interest rates converged, the international competitiveness of the German economy has steadily increased and the international competitiveness of the South has steadily decreased. The result was a German export surplus and an import surplus in the so-called GIIPS (Greece, Italy, Ireland, Portugal, Spain) states¹⁵. This import surplus was easily financed with capital imports to the private sector in GIIPS states, because interest rates dropped to a historical low in these states but still remained slightly above the rates in Germany. German capital exports financed government deficits at low interest rates and private investment, for instance a housing boom in Spain and Italy¹⁶. Therefore capital imports from Germany helped to build up a huge capital stock in the Spanish real estate sector. But these investments quickly ran into diminishing returns. Spain ultimately had a huge incremental capital stock, which generated little if any national income, but the interest for the mortgage loans had to be paid. By the same token since the introduction of the Euro the investment rate of the German economy went down to 5 percent of the national product with a savings rate of about 10 percent, the remaining 5 percent was capital exports. In other words the huge German export surpluses prevented the growth and modernization of the capital stock and retarded growth in Germany. The introduction of the Euro therefore had the perverse effect of building up a huge but unproductive capital stock in southern Europe whilst preventing the growth of the German capital stock and the modernization of the German economy. German banks found it more attractive to buy toxic assets in the USA and to lend money to banks in Southern Europe than financing firms in Germany. This was certainly an unintended consequence of the Euro, a loose-loose combination. It was good for Audi or Siemens, but it was equally bad for the German economy and for the economies in the South.

Why did this happen and why did the South lose competitiveness? Since the introduction of the Euro wage rates in the South increased much more than in Germany. Within those 11 years per unit costs of labor increased by 5 percent in Germany and by more than 30 percent in the southern countries. This increased

¹⁴ Jakob De Haan, Helge Berger, David-Jan Jansen (2004); Roel Beetsma, Harald Uhlig (1999); Marco Buti, Sylvester C. W. Eijffinger, Daniele Franco (2002)

¹⁵ See OECD Economic Outlook November 2011, pp and 21.

¹⁶ Hans-Werner Sinn (2006)

German exports and dampened German imports from the southern countries. I believe that the Euro is not sustainable and will not survive if this problem of diverging competitiveness cannot be fixed, regardless of which decisions the governments take with regard to budget deficits. A common currency is not sustainable if per unit wage rates diverge substantially over a long period of time. The way out would be to increase wages in Germany and to reduce wages in the south.

Let me now turn to the financial remedies, which, have been discussed during the present crisis: Eurobonds, the role of the central bank, the European Financial Stability Facility, the European Stability Mechanism, and the instrument of a sovereign insolvency procedure.

3. Eurobonds

Eurobonds would pool the public debts of all countries in the Euro zone. The former Eurocrat Jakob von Weizsäcker and many others have proposed such bonds as a solution to end the European debt crisis¹⁷. They include Romano Prodi, Jean Claude Juncker and Jose Manuel Barroso, to name just a few. The European commission proposed Eurobonds in a recent green paper in November this year. What would be the consequence of converting all Euro zone public debt into Eurobonds with a joint and several guarantee of liability? The interest rates for Greek, Irish, Spanish, Portuguese and Italian government bonds would fall dramatically as a result of a diminishing insolvency risk. Overall, this would imply a vast relief for the crisis struck countries. Those states, which are currently paying between seven and fourteen percent interest on their debt would perhaps manage to cope with three per cent. Consequently the solvent states such as Germany or the Netherlands would have to pay higher interest rates, since the additional risks of these countries going bankrupt would be priced into the new uniform interest rate. For example, in the event that the introduction of Eurobonds were to raise interest rates for German government bonds by one percentage point above the level without Eurobonds, this would amount to 20 billion Euros of additional interest payment per annum. It would not place Germany in a precarious debt situation; however it is equivalent to an increase of the value added tax by 2 percentage points.

Would this save the Euro? It all depends on how much autonomy will remain with the member states within the Euro zone in terms of assuming government debt. If everything else remains unchanged, any state may go into further debt to any desired extent. This is the counterargument of those, who maintain that the legal checks to curbing deficits do not work or are not credible

¹⁷ Christian Keuschnigg (2012); S. Eijffinger (2011); J. Alpha, J. von Weizsäcker: (2011); W. Bonstra: (2011); P. de Grauwe (2011); G. Horn (2011).

and that therefore automatic economic checks in the form of increasing interest rates would have to be in place.

Eurobonds would create huge incentives to continue borrowing beyond any measure, because in the event of a state bankruptcy, the costs can be offloaded to others. In the short term Eurobonds would certainly bring relief, but in the long run they might lead to a financial distress within all countries of the Euro zone and to a disaster for all countries.

Luxembourg's prime minister and chairman of the Euro Group Jean-Claude Juncker¹⁸ as well as the recent green book of the European commission proposed to convert all non-government debt into Eurobonds up to a volume of 60 percent of a state's national product. The president of the European commission has made similar proposals¹⁹.

Hence a country, which has 120 percent of public debt like Italy would be able to convert half of its debt into Eurobonds. If this would lead to a drop of interests from 6 to 3 per cent this alone would reduce Italian interest payment for public debt by some thirty billion Euros per annum. The remaining half would continue to have the underlying state as sole debtor. Creditors would then have to accept the default risk on the latter half of the debt. Arguably if the new stability pact negotiated by the heads of state in December 2011 would really work, the remaining risks for the guaranteeing states would be low. However, the new stability mechanism is untested. All decisions still remain with the council of finance ministers, the same council which was responsible for the destruction of the stability and growth pact, which seemed to be written in stone²⁰. Moreover, it gives little consolation that the German minister of finance was the main evildoer during this process of destruction. To this date, the only successful mechanism that has effectively checked government lending, has been the effect of additional credit on the interest rate of government bonds.

What about the legal problems pertaining to Eurobonds? They raise questions of European and of national constitutional law. Article 125 of the Lisbon treaty reads: "A Member State shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, ... of another Member State". The same rule holds for the European commission.

¹⁸ *Wirtschaftswoche*, 21.11. 2011

¹⁹ European Commission, Green paper on the feasibility of introducing Stability Bonds, Brussels, 23.11.2011

²⁰ One can therefore argue that the Juncker/von Weizsäcker proposal would not reduce the total interest payment of a troubled country at all. If its introduction leaves the total risk of bankruptcy the same Eurobonds would resemble a centrifuge. Someone pours milk in it (the national bonds as we know them) and on one side one gets skimmed milk (the risk free bonds with low interest rates). On the other side one gets butter (the highly risky bonds with high interest rates). The total risk and the total interest payments may remain the same.

Most legal scholars agree that this so called “no bail out clause” does not rule out direct credits of member states to another distressed member state as in the case of Greece or Ireland. It also does not rule out multilateral credits channeled through a European organization as the ESM. Joint liability Eurobonds would however violate the treaty and would therefore require a treaty amendment. This interpretation of Article 125 is widely shared. Also the European commission, which has been strongly in favor of Eurobonds since the outset of the crises wrote in its green paper in November 2011 “Issuance of Stability Bonds (the commission’s name for Eurobonds) under joint and several guarantees would a priori lead to a situation where the prohibition on bailing out would be breached. In such a situation, a Member State would indeed be held liable irrespective of its 'regular' contributing key, should another Member State be unable to honor its financial commitments. In this case, an amendment to the Treaty would be necessary.”²¹

The meeting of the heads of state in Brussels on 8 December showed how difficult it is to change the treaty even at the level of the heads of state. They took a decision not to change the Lisbon treaty at all but to agree on a new international treaty which comprises the member states of the Euro zone plus some others who want to join the Euro group. This will become an international treaty, similar to the Schengen agreement.

And this new treaty remains silent with regard to the question of Eurobonds and joint liability. There is nothing in it, which removes the no bail out clause of Article 125. Therefore the new treaty imposes stricter fiscal discipline on the states of the Eurozone than on other EU member states. But it leaves article 125 of the Lisbon treaty unchanged.

The necessary change of the no bail out clause, which could pave the way for Eurobonds, is not in sight. So far the following EU countries have announced that they oppose Eurobonds: Germany, United Kingdom, Finland and the Netherlands. The necessary consent in the European council to change Article 125 is not in sight at this point in time.

This is however not the only hurdle. If the heads of state of all 27 states in the EU would all agree on the change of article 125, it would still be questionable whether this change would be ratified in all countries. There are some well known problems with regard to ratifying a change of the EU treaty. I focus here on a particular problem of constitutional law in Germany. The German constitutional court had to decide on the constitutionality of the European Financial Stability Facility, which was declared to conform to the German constitution. But without mentioning the word “Eurobonds” in its decision of 7 September 2011 it stated in an obiter dictum. "The (German) Federal Parliament is not entitled to establish permanent mechanisms of international law, which

²¹ Ibid, p. 12

result in a liability for acts of other states, especially if the consequences of the risks involved are difficult to assess.”²² It is therefore possible and even likely that the constitutional court will strike down the ratification act of the German Federal parliament as unconstitutional, if this were to allow for joint liability bonds and if the court believes that “the risks are difficult to assess”. Should this happen it would imply a major drawback for solving the European debt crisis.

Assume for the sake of argument that all these legal problems can be overcome; there would still be a political constraint in Germany. The present government is a coalition government supported by the Christian democrats and the liberal free democratic party. The latter party made it clear that it will not support Eurobonds in parliament²³. If nevertheless the German government would propose to introduce such bonds, chancellor Merkel would lose her majority in parliament, without which she cannot govern. Consequently new elections would have to follow before Eurobonds could be introduced. After elections the chances might be better as both the green party²⁴ and the social democratic party have announced their support in favor of Eurobonds under the condition of better fiscal discipline in the Eurozone²⁵. And according to opinion polls they are likely to succeed the present government. Given these legal and political constraints I think it is credible that the German chancellor Merkel, who carefully avoids ruling out Eurobonds as a matter of principle, maintains that Eurobonds cannot help as an instrument to overcome the present crisis.

4. European Central Bank

What about the European Central Bank? Can it solve the crisis by buying bonds from troubled countries on the secondary market? Probably it could. I mentioned before that we would not have had the crisis, if the European Central Bank were able to act as a lender of last resort for the states such as the central banks in Japan, Britain and the USA. And especially the USA and Britain use this strategy. The Federal Reserve Bank²⁶ has bought 6 times as many bonds as the ECB and the bank of England much more than the ECB²⁷. If the ECB would follow the same policy it could for instance announce that it would buy Italian bonds until the underlying interest rates drop to a given level. But the Maastricht treaty, which established the ECB, carefully rules out this possibility. Article 123

²² http://www.bverfg.de/entscheidungen/es20111027_2bye000811.html (own translation from German)

²³ FDP im Deutschen Bundestag, Eurobonds mindern Anreize, Press release 23 November 2011

²⁴ Die Grünen, Bündnis 90, Bundestagsfraktion, Press Release, 30 November 2011

²⁵ www.spd.de/aktuelles/Eurobonds (last visited 28 February 2011)

²⁶ See above FN. 11

²⁷ 325 billion Pounds until 9 February 2012, Bank of England, Statistics, <http://www.bankofengland.co.uk/statistics> This is almost 80 per cent more than what the ECB holds from distressed countries.

of the treaty on the functioning of the European union prohibits direct credits from the central bank to any member state and the purchase of government bonds on the primary market.

When the ECB under president Trichet started to buy bonds of distressed countries some observers regarded²⁸ this as a circumvention of the prohibition of Article 123. This practice actually triggered the resignation of the former president of the German Bundesbank Axel Weber. In order to see whether these critics are right we have to look at the Lisbon treaty.

(Article 127) of the treaty reads „The primary objective of the European System of Central Banks shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Union“. This is a flexible formula and the ECB has the right and even the duty to help the general policy of member states, as long as this does not interfere with its primary policy target, price stability. And President Trichet was fully in line with the general economic policy as the European governments, including France and Germany supported or at least did not oppose the purchase of bonds from distressed countries. And thus far neither under the leadership of president Trichet nor under the present leadership of president Draghi, has the purchase of bonds from distressed countries had any inflationary effect. The money base remained unaffected because the central bank sold other assets of equal value and thus sterilized the consequences of buying bonds from distressed countries. In my view therefore the ECB has so far acted strictly within the confines of article 127.

As long as the European Central bank continues to buy bonds of distressed countries on the secondary market and sterilizes its effects by selling other assets it acts within the institutional framework of Article 127. This policy poses additional risks to countries of the Eurozone in case one of the debtor states needs a debt restructuring. This would lead to a write off and reduce the central bank's assets, hence its profits and the member states' share therein. In this case it would have a direct negative effect on the budgets of the member states. But so far no government of the Eurozone has criticized this risk seeking behavior of the ECB. The ECB can therefore trust that it supports the general policy of the member states and therefore acts fully in line with article 127. So far the Central bank has bought bonds from distressed countries worth 218 billion Euro²⁹. How long can it proceed with this policy without risking inflation? This is debated but the possibility to sterilize these effects gets exhausted at some level. There is no reason to believe that the ECB has any plans to deviate from the treaty

²⁸ In a letter of the former president of the German Bundesbank Axel Weber to the members of the Central Bank Council he criticized the purchase of government bonds by the ECB as a „clear violation of the treaty“ See Wall Street online 15 August 2011.

²⁹ Until the 8th week 2012, European Central Bank, Statistics <http://www.ecb.int/stats/>

obligations. The new president Draghi made it clear in several statements that nobody can give him any instructions, thereby alluding to article 130 of the treaty on the independence of the central bank. He also stressed that the role of the central bank to help distressed countries in this crisis is limited³⁰. There is therefore no indication that the European Central Bank will cross the red line and take the risk of inflation. In this respect the British and US approach to the crisis fundamentally differ from the approach in the Eurozone.

5. The European Stability Mechanism (ESM) and the European Financial Stability Facility (EFSF).

Should these observations be right it will be impossible to introduce Eurobonds within the next 2 years and the European central bank can and will intervene only with limited firepower within the confines of its primary stability orientation. This triggers the question, whether the other financial resources to fight the crisis are big enough to help distressed countries to avoid a state insolvency including debt restructuring.

The European financial stability facility has assets of 780 billions, but only on paper. If the contributions of those countries currently in distress are deducted, the lending capacity is only 440 billions³¹. Issuing bonds will leverage this to 1 trillion Euros. Any further extension, for instance by means of granting a bank license to the ESM, was denied. A bank license would have allowed the ESM to borrow money from the European Central Bank and then lend this to distressed countries.

On top of this one Trillion comes the fire power of the European central bank, which is however limited and I guess that it will not exceed 400 billion Euros. On Top of this come potential credits from the International Monetary Fund. Also, the 17 central banks within the Eurozone have agreed to make additional contributions to the International Monetary Fund. The amount of these contributions is still unclear but it will exceed 150 billion Euros. The German share of this contribution is 46 billion Euros³². This sum can again be leveraged by the IMF and the IMF can lend the leveraged sum to European countries in distress. Some of this money has already been spent on the rescue packages for Greece, Ireland and Portugal. The remaining sums available for future efforts to stabilize all distressed countries in the Eurozone will be lower than 1.5 trillion Euros, including the IMF credits. However, the total public debt of distressed countries in the Eurozone is 3.6 trillion Euros³³.

³⁰ Draghi: EZB kann Euro nur begrenzt helfen, News.de, 1 December 2012

³¹ www.efsf.europa.eu/about/index.htm

³² Die Welt, 31.12.2011

³³ For the end of 2010 the figure is 3.2 Billion Euros, See OECD, StatExtracts. In 2011 the additional lending fort he PIIGS states is estimated at

This leads to a simple calculation. The lending capacities of the IMF, the European Central Bank and the European Stability mechanism would be big enough to help Greece, Ireland, Portugal and Spain. They would also be big enough to help Italy for the forthcoming year, in which Italy has to roll over 300 billion of its public debt. If however this money is spent and if this is not enough to avoid a state insolvency in Italy, we are faced with the danger of messy state insolvencies in 2013.

How can this be avoided? It is difficult to imagine that all 17 parliaments in the Eurozone would agree to further increase the capital endowment of the European Stability Mechanism. If this observation is correct, three possibilities remain: either the sudden introduction of Eurobonds, or unlimited purchases of bonds by the ECB or a debt restructuring in distressed countries.

What is the best choice between these three evils? Such operations are emergency surgery and the rules of emergency surgery are different from the usual rules of medicine. Normal medicine tries to lead the patient to the best possible state of health. Emergency surgery attempts to keep the patient alive for the next hours or even minutes. There is a tradeoff between the optimal rules of emergency surgery and the optimal rules for general medicine. But if one compares different methods of emergency surgery one still has to rank them.

Eurobonds would immediately restore the creditworthiness in the short run. Can they be introduced in the short run? Given the legal constraints, on which I have elaborated earlier, this is questionable. But what would be the consequences of Eurobonds if they were introduced? Eurobonds are the worst alternative because they will probably be irreversible when the crisis has been overcome. Eurobonds would burden the triple A rated countries with the unimaginable sum of about 3.6 trillion Euros at risk. These countries would therefore have no other choice than to try to impose an iron fiscal discipline on all other countries with direct intervention of national budgets either by the European commission or the management of the European Stability Mechanism. This would imply a big push towards fiscal centralization in Europe, a higher centralization than in the USA or Switzerland, where such bonds do not exist even though in both countries a much higher level of democracy has been reached at the central state level as compared with the European Union.. It will be difficult if not impossible to reverse this trend after the crisis to abolish the Eurobonds and restore more fiscal autonomy in the member states.

What about the central bank? If the central bank were to cross the red line to avoid messy bankruptcies of member states thus increasing the risk of inflation, this would be a violation of the Lisbon treaty and it would burden all citizens in the Eurozone, whose wealth and real income is dependent on stable money. But the Central bank can easily return to its mission of price stability after the crisis. And unlike the European parliament and the commission it has an incentive to do so, because adhering to the rules increases the independence and

prestige of the central bank and its board members. From this perspective the social ranking between Eurobonds and a more active role of the central bank is clear. A temporary deviation from stability policy by the central bank can more easily be corrected than the introduction of Eurobonds, once the crisis has been overcome.

However, it is risky for the central bank and for the success of its crisis management to break the rules. Any member state might take action against the ECB at the European Court of Justice. Article 263 of the Lisbon treaty gives member states a standing in court against the ECB. It is however unclear and disputed what a state can claim. Any claim against an organ of the EU must be based on a particular action. The Lisbon treaty explicitly rules out the treaty violation procedure as an action against the central bank, a tribute to its independence. A state can only base a claim on a nullification procedure. This is possible if an act of an organ of the European Union violates an entitlement or right of the claimant. But what should be nullified here? If the central bank buys bonds of a troubled state, the legal form of this policy is a sales contract with a bondholder, which certainly does not violate any entitlement of a member state and therefore cannot be nullified. One could then argue that the policy of the European Central bank is based on committee decisions of the central bank council and that such a decision can be nullified. But here the problem arises that the committee decision again does not directly infringe a legal position of a member state. Here we are on untested legal ground. In any case it is thinkable that a member state brings the central bank to court and the court nullifies a policy decision of the central bank council, if this violates the treaty of Lisbon. Such a decision could cause a mess in financial markets.

Can a European citizen take action against the European Central Bank? Citizens have standing in court, if illegal acts of a community organ, including the central bank, directly affect them (Article 263). But courts worldwide do not regard inflation as a property violation in the legal sense. In the event of hyperinflation this might be different. Therefore there is no danger that citizens might strike down an emergency operation of the central bank at the European Court of Justice.

Monetary easing and low interest rates cannot guarantee an increasing investment demand. If banks neither trust private investors nor other banks Central Bank policy might not be sufficient to boost private investment and growth. And fiscal tightening reduces government as well as private consumption. This can lead to low or negative economic growth in troubled countries. The ratios Public Deficit/GDP and Public debt/GDP then implies the necessity, in financially weak countries, of making restrictive pro-cyclical macro-economic policies even during severe crises as in the 2008-2012 period. This leads to cumulative effects and deeper crises, which reducing GDP, the denominator of the two ratios, induces further restrictive measures, as in the Greek or the Portuguese, or the Italian case. To avoid this downward spiral fiscal

discipline can be combined with more public and state sponsored private investment. European organizations like the European Bank for Reconstruction and Development (EBRD) could finance infrastructure projects as well as private investment. Many European politicians call for a growth initiative, a Marshall plan for the troubled states. Also, supply side reforms and economic liberalization produce losers, who object the reforms. European initiatives can compensate losers of national reforms, for instance by financing training programs for the jobless especially for the young jobless. The EBRD issues bonds, which are guaranteed by member states. This practice does not violate the European treaty or national constitutional rules and can be used without groundbreaking institutional changes in Europe. Combined initiatives of the European Commission and the EBRD are therefore instruments to boost growth and to overcome political opposition against supply side reforms. They are on the agenda after the elections in France and Greece.

The third emergency option is a debt restructuring in the troubled countries a so called haircut. This would lead to huge losses of banks, investment funds, pension funds and hedge funds around the world. Given the size of the Italian economy and its debts of 1.9 trillion Euro, this would lead to a bankruptcy of many of these institutions. To avoid a conflagration many of these institutions would have to be rescued and recapitalized by the European taxpayer, but also by tax payers in the UK, USA and other countries. Lucke has recently estimated that the costs for the European taxpayer would be a small fraction of the costs needed to avoid a state insolvency, because the equity capital of financial institutions in the Eurozone is at risk first³⁴. This capital would disappear once the bonds have to be written off. This is also the only remedy in line with the principles of a market economy, which allocate risks to the owner of capital at risk and provides the right ex-ante incentives for creditors.

The distributional effects of European state insolvencies would antagonize other countries outside the Eurozone, especially Britain and the United States. Only a part of these credits are held by financial institutions within the Euro zone. The costs of this solution –as compared with Eurobonds and inflationary policy – would be born by equity holders of financial institutions and by taxpayers in many countries. The European taxpayer would however save money compared to the other options. The institutional framework for such a solution will be in place as soon as the European Stability mechanism is established, probably in mid 2012.

The second protocol of the European Stability Mechanism contains elements of a state insolvency procedure, which consists of elements from private as well as international law. It consists of three basic elements. First: The procedure is initiated when a debtor country applies for a credit from the ESM.

³⁴ Harald Hau, Bernd Lucke (2011).

This also imposes a kind of standstill for the creditors, especially an obligation to extend overdue credits. Second: A team of experts from the EU commission, the European Central Bank and the International Monetary Fund prepares a report for the council of the ESM. In exceptional cases this results in a haircut or private sector involvement³⁵. The bottom line of this report is an assessment whether the crisis is a liquidity crisis or an insolvency crisis. In the latter case the ESM will grant new credits to the distressed country only if the debtor country has negotiated a debt restructuring before, a so called haircut with the creditors. Third: the legal basis for these negotiations between the debtor country and the creditors will be collective action clauses, which will be part of all future bond contracts with governments in the Eurozone. These collective action clauses allow a supermajority of debtors to forgive parts of the debt, and they also transfer the rights of legal action against a debtor from the individual bondholder to a trustee. The latter excludes disruptive activities of so called maverick funds and specialized law firms against foreign assets of the distressed debtor state. Only after the negotiation of a haircut will the ESM credits flow if finance ministers come to the conclusion that the crisis is an insolvency crisis and not a liquidity crisis.

Assume now that the crisis unfolds over the next two years and the only possibility to save the Euro would be either to introduce Eurobonds, or an active role of the ECB or a haircut in the framework of the ESM, the ranking of alternatives should be clear. The haircut combined with a rescue net for financial institutions would be better than inflation caused by the ECB and inflation in turn would be better than Eurobonds with their long lasting effect on the loss of financial autonomy and a drive towards fiscal centralization with an erosion of national democracy without replacing this by more democratic European decision procedures.

A haircut would antagonize governments outside the Euro area because their financial institutions would also suffer and they might have to fix problems of recapitalizing banks with their own taxpayers' money. This prospect is one of the reasons why western countries outside the Eurozone try to push governments in the Eurozone to even larger rescue funds and urge the central bank to buy bonds on the secondary markets. They do not want to share the risk. But a debt restructuring can be the solution with the least overall disruptive effects and would provide the right ex ante incentives. And after the Lehman crisis, which placed such a high burden on Europeans it is only fair to shift back some of the burden if necessary. I might quote Adam Smith here who wrote in the *Wealth of Nations* "When it becomes necessary for a state to declare itself bankrupt, in the same manner as when it becomes necessary for an individual to

³⁵ EU, Treaty Establishing the European Stability Mechanism, 2 February 2012

do so, a fair, open and avowed bankruptcy is always the measure which is both least dishonourable to the debtor, and least hurtful to the creditor”³⁶

Before I close I get back to the most disturbing underlying cause of the crisis, which I mentioned at the beginning, the growing disparity of per unit labor costs in Germany and the South. This leads to an increasing international competitiveness in Germany and a declining international competitiveness as well as a loss of employment in the South. If this problem cannot be fixed, no cure in the financial sphere can work in the long run as long as we have a common currency. This problem cannot be solved quickly. It will take years. The survival of the Euro will ultimately depend on whether Europe can successfully solve this problem.

³⁶ Adam Smith (1776), pp. 564–565. New York 2009

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