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Editorial

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Die Forschung in den Wirtschaftswissenschaften wird zunehmend internationaler. Schreibt ein Wissenschaftler eine Studie beispielsweise über das deutsche Bankensystem, so möchte er vielleicht diese mit anderen einschlägigen Arbeiten über das schwedische oder spanische Bankensystem vergleichen. Umgekehrt möchte er, dass seine Arbeit auch international wahrgenommen wird und insbesondere möglichst auch zitiert wird. Auch aus praktischer Sicht nehmen Themen, die nicht nur von regionaler Bedeutung sind, tendenziell zu.

Zwei Eigenschaften sind wichtig für eine wirtschaftswissenschaftliche Zeitschrift. Erstens sollte sie auch international einen hohen Bekanntheitsgrad haben und eine gute Reputation genießen. Ein englischer Titel für die Zeitschrift ist dafür hilfreich, wenn nicht sogar notwendig. Wir haben daher entschieden, den alten Titel *Kredit und Kapital* so sanft wie möglich ins Englische zu übertragen. Der neue Name *Credit and Capital Markets* hat einen hohen Wiedererkennungswert, sodass bruchlos an die bisher 45-jährige Tradition der Zeitschrift angeknüpft wird. Wir hoffen, dass die Namensänderung von unseren Autoren und Lesern angenommen wird. *Kredit und Kapital* hatte von jeher einen gewissen inhaltlichen Fokus auf Themen des Finanzsystems im deutschsprachigen Raum. Dies kann und soll auch weiterhin so bleiben, die Wahrnehmbarkeit jedoch soll auch international erhöht werden.

Zweitens wird die Rezipierbarkeit eines Artikels mitbeeinflusst durch die Sprache, in der er verfasst ist. National werden deutschsprachige Artikel wahrscheinlich besser angenommen, international jedoch englischsprachige. Da also für unterschiedliche Aufsätze eine andere Sprache optimal sein kann, möchten wir unseren Autoren daher weiterhin freistellen, die Sprache ihres Aufsatzes selbst zu wählen. Titel und Zusammenfassung bleiben zweisprachig.

Als weitere Neuerung werden die Herausgeber durch einen wissenschaftlichen Beirat (*advisory board*) unterstützt. Auch in der Zusammensetzung des Beirats spiegelt sich die inhaltliche wie regionale Ausrichtung der Zeitschrift wider. Der Beirat setzt sich zusammen aus Sylvester C. W. Eijffinger (Tilburg), Daniel Gros (Brüssel), Jürgen von Hagen (Bonn), Hans-Helmut Kotz (Frankfurt, Freiburg), Lars Norden (Rotterdam), Marliese Uhrig-Homburg (Karlsruhe), und Marco Wilkens (Augsburg). An dieser Mischung erkennt man das regionale Standbein der Zeitschrift, mit Verstärkung aus dem europäischen Ausland. Auch die inhaltlichen Schwerpunkte der Zeitschrift in Finanzwirtschaft, Kapitalmärkten, Geldpolitik und International Finance sind gleichmäßig abgedeckt.

Im Vordergrund sämtlicher Bemühungen steht natürlich letztendlich der Leser. Wir wünschen daher nun eine interessante Lektüre.

Ansgar Belke, Hans-Peter Burghof und *Hendrik Hakenes*

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Policy Issues

Reinforcing EU Governance in Times of Crisis: The Commission Proposals and Beyond

By Ansgar Belke, Essen and Berlin*

I. Introduction

The extensive package introduced by the Commission is the "*most comprehensive reinforcement of economic governance in the EU and the euro area since the launch of the Economic and Monetary Union. Broader and enhanced surveillance of fiscal policies, but also macroeconomic policies and structural reforms is sought in the light of the shortcomings of the existing legislation. New enforcement mechanisms are foreseen for non-compliant Member States*."

In this very crucial and important package of 6 legislative dossiers this paper tries to:

– help to identify critical missing, or redundant/unworkable, elements within the Commission package, and,

– check what (if anything) is missing outside and beyond the proposals in order to make the whole package of governance reform complete and workable (crisis resolution mechanisms and debt restructuring, European Monetary Fund (EMF), project bonds, Eurobonds etc.).[1]

* This paper heavily relies on a briefing paper presented by the author as a member of the "Monetary Experts Panel" at the Committee on Economic and Monetary Affairs of the European Parliament for the quarterly dialogue with the President of the European Central Bank, Brussels, November 30, 2010.

[1] The full set of legislative documents that has been put forward by the Commission contains a wide range of proposals such as (i) COM(2010) 526 amending Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies (ii) COM(2010)522 amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure (iii) COM(2010)523 on requirements for budgetary frameworks of the Member States (iv) COM(2010)524 on the effective enforcement of budgetary surveillance in the euro area (v) COM(2010)527 on the prevention and correction of macroeconomic imbalances and (vi) COM(2010)525 on enforcement measures to correct excessive macroeconomic imbalances in the euro area.

Although the paper analyses only a snapshot in time during the dramatic events around the euro area debt crisis and the multiple efforts to solve it, it might serve as a helpful device to get acquainted with the incentive structure of the main problems and players involved.

II. Clear Change in Perspective after European Council Meeting

1. The Package Deal Following Deauville

At the European Council meeting of October 28–29, 2010, the heads of state came up with a quite striking package deal which was prepared a couple of days before at the bilateral French-German summit in Deauville. It changed the context of the legislative proposals on EU economic governance of 29 September 2010 decisively: the result was an unanimous agreement to conduct a "limited" Treaty reform, which in turn puts Germany in a position to agree to a permanent crisis resolution mechanism, i.e. a permanent successor to the temporary three-year European Financial Stability Facility (EFSF).

Especially German politicians do not grow tired of announcing that the planned crisis resolution mechanism which will in the future call on private creditors for the financial recovery of ailing euro area member states will be implemented not earlier than 2013, the date by which any limited treaty changes can be ratified. But provisions are said to have been made in May 2010 *against every possible development in the years until 2013*. The responsibility of filing a petition to help rests upon each member state if a country should believe it is in need of this support. This paper will later on argue that the notion of "every possible ..." is not generally applicable in this context because the billions of euros ascribed to the EFSF package are gross values which might be enough to cope with a default of Greece and Portugal, but certainly not if Spain would also be involved.

France agreed to the proposal for a so-called permanent crisis resolution mechanism in exchange for Germany yielding to France's desire for *more lenient rules for states that break the EU's debt and deficit limits* (*Belke,* (2010b)).

2. *"Just Adding a Few Words"*

The agreement included a commitment not to change the so-called no bail-out clause (Art. 125 TFEU), but simply the already now proverbial "*addition of a few words*" to one or at a maximum two articles in the Treaty, among them Art. 122 TFEU (Treaty on the Functioning of the European Union). Just adding a reference to financial stability in Art. 122 was obviously assessed to be sufficient to satisfy the German Constitutional Court. At the same time it was intended to serve as a solid legal basis for the new permanent crisis solution mechanism which might amount to a permanent EFSF and will not necessarily explicitly appear in the wording of any Treaty change explicitly. The reason is that the "permanent EFSF" as a new EU institution falls outside Part 3 of the TFEU, and therefore cannot be created according to the simplified revision procedure (*Gros/ó Broin/Kaczyński* (2010)). The perspective of an only small Treaty change which allows for the use of the simplified treaty revision procedure and avoids the need for a referendum, let all 27 members agree. Another driving force was the insight that no crisis solution or insurance mechanism would be realistic which is not supported by the two largest (donor) euro area countries (*Belke* (2010b); *Gros/ó Broin/Kaczyński* (2010); *Haede* (2010)).

The summit meeting also came up with the conclusion that the IMF would play a role in the new mechanism, but did not make its role more concrete (*Belke* (2010b)). This probably implies that the new mechanism will be accessible only to governments which have complied with IMF conditionality as it was the case with respect to the recent 110 billion (80 billion EU and 30 billion IMF) rescue package for Greece.

Seen on the whole, the situation *does not seem to be under control* up to now. Sovereign bond spreads are flickering these days to heights not seen during the last months. On November 12, 2010, spreads in Portugal were close to 500bp. In Spain, spreads were approaching the 230bp level at the height of the Spanish crisis in the summer, and the Belgian spreads have reached 100bp for the first time. Italian spreads also went up, though pressure has lowered a little bit in Ireland – but this is probably due to some support from the ECB. The explanation for these lingering doubts is quite simple: the problems that underlie the crisis (the precarious state of Greek public finances and that of the Spanish real estate sector) have not been solved.

It cannot be excluded that – within the next weeks – politicians will be forced to go for quick shots. The main danger is that there is *no fallback position* if countries beyond Ireland have to be rescued. Up to now there is a *legal vacuum* how to organize both an orderly and a unscheduled default *in the euro area* (in contrast to the detailed descriptions underlying international bonds issued by emerging market countries). The EFSF framework was meant to but would not cover the worst case in which Greece, Portugal, Spain and Ireland would all become needy. However, in reality the true liability limit of the EFSF framework would not be able to cover the case of, for instance, Spain, if the smaller countries would have become needy as well. The reason is that significant sums have to be deducted from the EFSF's total volume of 440 billion euro beforehand for general stabilization measures and maybe also – and this is often forgotten – utilized for guaranteeing some donors' claims.

3. Large-Scale Problems of the Status Quo

The scale of the current debt problem is large. For Greece, 110 billion euros have already been agreed upon. The EFSF plus EFSM (European Financial Stability Mechanism) headline amounts to a nominal value of 500 billion euro, which in reality corresponds to a sum of 255 billion euros, due to a couple of deductions. Most importantly, only those countries can act as guarantors for other states if they have an AAA rating, i. e. the highest credit rating: Germany, France, the Netherlands, Austria, Finland and Luxembourg.[2] If the needs of Ireland and Portugal are considered to be of the same magnitude as Greece, this directly implies that the package might not be able to deal with Spain. If Portugal and Ireland turn to the EFSF then only the ECB can prevent financial market meltdown.

The first basic problem addresses the fact that the euro area is a monetary union, but not a fiscal or even political union. This is precisely why there is no guarantee clause (note that we later on argue that Art. 125 TFEU is not a "no bail-out" clause). "No bail-out" is not credible with integrated financial markets. When markets are close to meltdown creditors have little choice.

[2] Correspondingly, the IMF would provide net credits at the amount of only 160 billion euro. In sum, analysts estimate that, hence, a total of 475 billion euro could be paid out as financial support.

Deciding on the way of "bailing in" the private sector is the second fundamental problem. The European Council was faced on October 29 with the pioneering question whether it should agree on a permanent "crisis resolution mechanism" demanded by markets and debtor countries in exchange of a "bail-in" mechanism as demanded by Germany. The existence of the turning point per se and its actual solution have initiated huge turmoil in the markets.

Hence, details of the envisaged involvement of the private sector should be resolved quickly. Should it take place always? Should one redesign the timetable of repayments without altering the present value of the former (rescheduling) or even diminish the present value down to a level which appears to be sufficient to arrive at sustainable public finances (restructuring)? What about haircuts? Should they only be applied to new debt or should old debt also be considered?

Otherwise we might see tensions rising between the "North" and the "South" of the euro area. On the one hand, there is the view of the German Chancellor Mrs. Merkel who interprets Art. 125 TFEU as a "no bail-out clause" and argues accordingly that the monetary union cannot become a transfer union. Hence, the "North" sees a member state failure as an option. This necessitates tough conditionality and rules for orderly bankruptcy. On the other hand, Mr. Trichet – really standing for the "South"? – does not stop claiming that "we are all in the same boat". In that sense, a member state should not be left alone if it is in trouble. In the extreme, this view implies that there is neither a plan B necessary nor is there any floor to the rating of collateral foreseen at the ECB.[3]

In the wake of the October 29 European Council, the tensions between the "North" and the "South" came back on the scene. The aim of policy should thus not only be to prevent failures. Rather it should also prepare for it. An EMF could be based on permanent EFSF. Since the available collective action clauses are insufficient, there is the necessity of mopping up law.

It has to be mentioned that there are a couple of differences in sovereign and private defaults. Therefore, sovereign-debt crisis are more complicated to deal with, since instruments to handle the situation in an orderly way are much more limited than in the case of private debt. In the latter case, the problem can be solved by liquidating the borrower's as-

[3] I gratefully acknowledge comments from Daniel Gros on this issue.

sets and, referring to corporations, dissolving the organization (*Gianviti* et al. (2010), p. 19).

These preliminaries should serve as the background against which missing or redundant and/or unworkable elements within the Commission package can be identified.

III. Missing or Redundant/Unworkable Elements within the Commission Package

1. Unworkable? SGP Sanctions and Voting

An important issue is to what extent quasi-automatic sanctions and a reversal of the burden of proof in the EDP would influence market perceptions. It is conceivable that in this case alone the triggering of the EDP could lead to major reactions by market participants. However, this problem is also inherent in the proposals referring to the permanent crisis resolution mechanism – although in a few of the Sovereign Debt Restructuring Mechanism (SDRM)-type proposals this is intended to be mitigated by inferring the role of a "judge" to the SDRM (section 3). On the other hand, such a change in processes of this kind – just like the European semester – would clearly signal a paradigm shift towards more serious budget coordination that could be rewarded by the markets.

However, reversed voting raises also fundamental questions about democratic accountability. Hence it would be desirable to involve the European Parliament in the Excessive Deficit Procedure (EDP) and Excessive Imbalance Procedure (EIP). For example, one could stipulate that the Commission should pass first before the relevant Committee of the European Parliament before presenting proposals for sanctions to the Euro Group.

Moreover, the central role of the Commission as an impartial, technical body contradicts the existing tendency of the Commission to become a more political body (for example the President of the Commission now has to come from the majority fraction in the EP, which he/she is likely to remain in close contact). This implies that Commission proposals for sanctions could easily become (or just be seen) as the result of party politics and not the neutral assessment of an independent and highly professional body. Thus, inverting the voting mechanism would make sense only if process (in particular the proposals on fines) is under the control of an independent EU fiscal authority along the lines of the independent fiscal agencies that are proposed for the national level.

2. Unworkable? SGP Preventive Arm Based on Cyclically Adjusted Variables

Given huge difficulties in identifying the cycle and the structural element, especially during critical times, it is unlikely that the preventive arm can be strengthened so much that coercive measures can be imposed on the basis of estimates of cyclically adjusted data. This is especially relevant to the assessment of the output gap and, thus, also the structural budget deficit.

3. Missing: Strong Incentives to Stick to the Rules

A *more comprehensive framework of ex-ante policy coordination* including a "European Semester" has been decided by the Council. Procedural changes to the Semester may be implemented after the European Parliament has voiced its concerns in the coming months. In the latter 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. 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 (*Belke* (2010), p. 15).

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.

4. *Missing: Clear Definition of the IMF's Role*

Is there any, and if yes, what role for the IMF? The Van Rompuy Task Force enumerates the role of the IMF among the issues to be addressed for a new future permanent mechanism, especially with an eye on the very strong conditionality under which programmes like a permanent crisis solution mechanism should operate. The IMF is mentioned neither in the EU Commission proposal from September 29, 2010, nor in the following positions on the former articulated by the European Parliament.

5. *Critical but Unavoidably Missing (after end-of-October EU summit): Reversed Qualitative Majority Voting on SGP Sanctions and Withdrawal of Voting Rights*

The results of the EU summit on October 28–29, 2010, have to be appreciated if indeed a crisis solution mechanism which really deserves its name will result in the end. It would put an end to the large-scale problems described in section 1 – especially because it would terminate the role of the ECB as the bad bank of the euro area. The very existence of this mechanism would be much more important than the withdrawal of voting rights in EU committees, if a country repeatedly cheats with respect to the deficit rules. In terms of game theory, the threat of withdrawal of voting rights has been strategically employed as a "whipping boy", in order to dispose of some items to sacrifice for a package deal.

What is more, a hardened Stability and Growth Pact has to be regarded more as a complement than a true alternative to a successfully designed government insolvency mechanism. Hence, one could feel legitimized to argue that an only partial hardening without "automatic" sanctions, as it is now envisaged, is acceptable. Particularly since the majority of the proposals by the EU Commission to provide the SGP with sharper teeth, is still included in the package (*Belke* (2010)).

6. *Unworkable: Differentiation Between Proposals for Eurozone and Non-Eurozone Countries*

With regard to economic policy, the differentiation between proposals for euro area and non-euro area countries is likely to become an issue. Such a differentiation is made in the documents drawn up by the Commission and is supported by the Van Rompuy Task Force: potential sanctions and conditionality will play a lesser role with non-euro area countries. Also scoreboard thresholds may be different between euro area and 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. It is thus overall plausible to take "into consideration the very close interconnections with non-euro area economies, especially those that are expected to join the euro area, as part of the new multilateral surveillance framework and the enhanced instruments of the SGP and, in particular, a stronger focus of the MTFO" (*Feio* (2010)).

This issue is relevant since – with respect to the issue of a crisis solution mechanism (on which the EU Commission is silent) – Mr. Feio is correctly claiming that it should also be carefully assessed whether non-euro area Member States could possibly join the European financial stabilisation mechanism on a case-by-case basis and after fulfilling pre-defined criteria.

7. *Unworkable: Interpretation of Art. 125 TFEU as a Strict "No Bail-Out Clause"*

Upon closer examination, one reading of the Article is that countries like Greece do not have a legal entitlement for guarantees or even payments from the Union and other member states but that it does not prohibit the former. However, the EFSF framework has de facto been established anyway. Hence, there is a clear need of changing the factual constraints. Otherwise Art. 125 TFEU would become teethless. In this sense, the "no bail-out" rule under a solution like the EMF would be more credible than the "no" under Art. 125 TFEU.

8. Redundant: A Scoreboard Establishing a Set of Indicators Revealing External and Internal Imbalances

Basically, it makes much sense to avoid "harmful" macroeconomic imbalances. But up to now there is no technical solution for the problem of determining the exact threshold beyond which an existing imbalance is "harmful" and to whom it is harmful ex ante. However, there is point in more generally monitoring large external deficits (and also the share of foreign debt in overall debt figures playing a role within the Commission package). The latter makes countries prone to a "sudden stop" to the capital inflows and the connected dangerous dislocations in financial markets potentially spreading all over the euro area (*Gros* (2010 a)). Since the public deficits are frequently driven by private deficits – as in the cases of Ireland and Spain – also the Eurosystem bears a large part of responsibilities in allowing bubbles in national housing markets and the associated increases in private debt to develop (*de Grauwe* (2010)).

It directly follows that the best policy response does not seem to be a narrow focus on competitiveness indicators, but rather on the prevention of underlying causes of the imbalance, which are usually divergences in domestic demand (often driven by credit-financed real estate and/or consumption booms). Or even wait for the automatic reversal of the imbalances. This might be a favourable and dominant strategy with an eye on the German example according to which current account surpluses led to a stimulus for domestic demand which, in turn, supports wage growth, ceteris paribus lowers competitiveness and the current account surplus. Hence, one of the basic insights of international economics is that *current account imbalances* are *endogenous* and driven by autonomous and complex savings and investment decisions. What is more, it should be clear that a specific country cannot import more than it exports for an unlimited time and the other way round. If at all, thus, any focus should be put on the duration of imbalances not on the imbalances per se. But again: who should decide on the threshold? And on what basis?

Moreover, a rigid and mechanical application of such a large assemblage of different indicators may lead to ambiguous results and, thus, lead to confusion. This, in turn, would negatively impact on the effectiveness of monitoring and potential sanctioning. For instance, how to react if some indicators point at one direction and a couple of others at another? How to aggregate the evidence? If aggregation is agreed upon, what are the weights? Anyway, most cases in which member states get into difficulties cannot be exactly traced back to the empirical realization of one or another economic indicator. Instead, these cases are related to inadequate governance of an array of imbalances prevalent within a country (*Bruegel* (2010); *Fahrholz/Wójcik* (2010)).

Finally, a definite strength of the proposals contained in the EU Commission package is that it is *not* treating surplus and deficit countries *symmetrically*. By this, it proves to take a true global perspective and to acknowledge the negative effects on the *international* competitiveness of the euro area that would emerge with respect to the rest of the world in case of adjusting competitiveness indicators in a symmetric fashion (*Belke/Schnabl/Zemanek* (2010)). Opponents to this view appear to be driven by the (wrong) perception that the deficits of some member countries are numerically exactly offset by the surplus of others, i. e. in a symmetrical way. Of course it is tempting now to apply closed economy reasoning and to suggest that both enhancing competitiveness of the deficit countries and lowering competitiveness of the surplus countries lead to a reduction of imbalances, since competitiveness is always defined in relative terms. But the euro area is faced with an increasing degree of globalization and would thus as a whole really suffer welfare losses from any competitive adjustment "to the middle", in terms of an overall loss of competitiveness for the entire area (*Bruegel* (2010)).

To summarize, as frequently warned by economists like Richard Baldwin, the EU Commission and national governments are expected to have great difficulties in steering trade and current account deficits. Concrete numerical goals as also discussed at the G 20-summit in Seoul on November 5, 2010, are not more than catchwords. Hence, it turned out to be a nearly safe bet that governments agreed upon more than the mere closing declarations, because anything else would be too difficult to implement.

9. European Semester: Unworkable Element?

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* (*Belke* (2010) and the sources cited therein).

10. General Remarks

The European Council agreed to follow most of the proposals included in the EU Commission package, i.e. to tighten the SGP and to set up a system aimed at reducing macroeconomic imbalances produced by a lack of convergence of economic policies within the euro area. It obviously took the view that the main source of the euro area debt crisis has been the "misconduct" of national governments which have permitted their budget deficits and debt levels to explode and have implemented too few measures to avoid divergent movements in their economies. While this view is partly true, it clearly neglects the "hot potato game" characterizing the financial crisis, i.e. the fact that unsustainable increases in private debt (of households and financial institutions) forced many governments to bail out the private sector (and, in the end, forced the ECB to collect the pieces). Excessive bank credit enables the emergence of these bubbles and made them more intense, as could be seen in Ireland and Spain. In the long run, only the central bank but not the governments can control bank credit, the conditions for lending and the development of unsustainable private debt levels (*de Grauwe* (2010)).

Reforms of the economic governance in the euro area should therefore not only focus on the serious responsibilities of national governments – as done in the Commission package – but also on those of the European monetary authorities, and in particular those of the ECB. After the Lehman collapse, European policy (including monetary policy and the EU Commission package) followed the principle that the insolvency of governments and banks had to be prevented under all circumstances and accepting any costs. With an eye on the sustained bond market turbulences, this way could be labeled as a fiction. The compromise agreed upon at the European Council meeting of 28–29 October clearly turns away from this principle and, thus, should be basically welcomed. The status quo European rescue package has to be urgently substituted by a permanent crisis mechanism. And this has to do with current ECB monetary policy: the level of the current ECB main refinancing interest rate shields Ireland and Greece from insolvency. This is an important aspect neither taken into account nor explicitly tackled within the EU Commission package.

All the discussions about a potential "bail-out" of countries within the framework of the current rescue package neglect the fact that a much larger bail-out can be read off the ECB balance sheet. With a focus on the purchases of "toxic" government bonds by the ECB within the SMP, it can be argued that the ECB intervenes in "dysfunctional markets" for government debt in a sterilized but completely discretionary manner. This *must* effectively lead to a redistribution of risk among member states (*Belke* (2010)).

However, an even more alarming aspect the public might not be sufficiently aware of is that the ECB supports the respective member countries and their banks in the framework of its ordinary monetary policy operations. The ECB grants the troubled and distressed commercial banks to refinance hundreds of billion euros, i.e. 40 to 50 percent of GDP for Ireland respectively Greece, at a tiny one percent interest rate. As expressed in the FT Editorial from November 16, 2010: "Irish banks only survive thanks to European Central Bank lending: they currently suck up about a quarter of the ECB's liquidity provision. … But the sickliness is part of why sovereign yields have spiked, troubling the bond market of other peripheral European states." Without this transfer of nearly free money, both countries would almost certainly have gone bankrupt some time ago. Assuming that Greek banks should have to pay the same risk premium as the Greek government, ECB lending to Greece amounts to a subsidy worth more than the transfer from the EU Structural Funds (*Gros* (2010b)). Notably, referring to the Quantitative Easing (QE) programmes conducted by the Fed is no excuse here, because US QE cannot at all be compared to the quasi-QE programmes conducted by the ECB, since the latter does not target its bond purchases to, for instance, Florida or other specific federal states.

As already mentioned in section 1, the ECB is now the buyer of only resort for Irish bonds, possibly the only policy institution able to prevent the collapse in Irish and Portuguese bonds from spreading. But this may imply that Mr. Trichet has to ignore opposition from within the ECB council to the ECB's bond-buying program and further expand purchases of sovereign assets.

Taking these considerations as a starting point, it seems fair to state that the Commission/Euro Group *do not* have submitted a proper adjustment programme which really covers the central issues. Just changing the SGP which represents a significant part of the Commission package is not *the* issue – this appears to be not more than a sideshow which will not lead to significant solutions to the large-scale problems of the euro area described earlier. A further central problem would be the democratic legitimacy of imposing fines according to the exact realization of figures. This in itself speaks in favour of a bottom-up approach in the shape of, for instance, fiscal limits hard-coded into each country's legislation in the form of automatic, binding and unchangeable rules (*Belke* (2010)). Hence, one should deal with the question neglected by the Commission package: "What happens, if …?". Let us now check what (if anything) is missing outside and beyond the proposals in order to make the whole package of governance reform complete and workable.

IV. What (if Anything) is Missing Outside and Beyond the Proposals in Order to Make the Whole Package of Governance Reform Complete and Workable?

1. Eurobonds – Really Missing?

On November 6, 2010, Mr. Juncker was quoted by Reuters to propose a European bond. He said he would make a formal proposal for a common Eurozone bond. He is quoted as saying: "It's an intelligent way to keep economically weaker euro countries attractive for investors in the future." However, this argument should not be bought completely. The only argument to justify the introduction of Eurobonds is to defragment the EU bond market and to create an alternative for Chinese (or Russian) investors who up to now still invest in safe T-bills – in spite of increasing doubts in the US macro policy stance and their fear of returns being inflated away after a while. Since the euro area should be prepared to go for larger current account deficits if China will stick to its export model also in the future (as all projections say) and the US really strive for lower deficits, defragmenting bond markets might be a contribution to lower global imbalances (in accordance with the position by Mrs. Berès on the crisis resolution mechanism). The arguments speaking against the introduction of Eurobonds are broadly similar to those brought in against the Securities Market Programme (SMP) and, hence, shall not be enumerated again in detail. Most important, their introduction would massively drive up Spanish and Portuguese bond yields because investors would run for the safe haven "euro bond".

2. *Missing? Bank Recapitalization as a Condition-Sine-Qua-Non*

As shown in section 1, large-scale problems of the status quo appear at the surface in the euro area because there has not been any solution to the deficiencies which drive the crisis, among them the still alarming stances of the Spanish real estate sector and Greek public finances. In this context, it is remarkable that the proposals do not tackle at all the still *significant undercapitalization of the European banking system* – a second important driving force of unsettled financial markets. *Gros* (2010), for instance, reports based on euro area statistics that for every capital loss of one euro held by some euro area bank, there is about € 20 of doubtful debt (liabilities including interbank debt).

But, strikingly, all proposals implicitly assume that European funding will be used only to bail out governments which in turn might apply these funds to bail out their own banks. The word "bank" does not even appear in any of the proposals although the banking issue is deeply connected with the state of public finances and the necessary volume of an emergency fund. But, taking the 20:1 liability-capital ratio in the banking sector as a starting point, this way of handling this critical issue implies that the public funding requirements within a potential crisis resolution mechanism may become much higher than if undercapitalization would be dealt with directly (*Gros* (2010)). The proposals should at least mention these fundamental relations and, even better, explicitly combine their concepts with a hint at the need for continuous rigorous stress testing of euro area banks and subsequent mandatory recapitalization (as long as Basle III is not fixed but only agreed upon by the G-20). It is necessary but not sufficient to blame the Club Med countries for unsustainable fiscal policies.

However, these insights have to be carefully weighed against that fact that the main root of the problem in Ireland (i.e. the source of doubt about its solvency) besides weak banking supervision has been the government's overly strong commitment to bank bondholders at any costs. This might translate into a great risk for the taxpayer since ECB Vice-President Vitor Constâncio has publicly considered that EFSF money could be used to back Irish banks. This paper argues that this would, however, be a mistake and, thus, sovereign bonds will then continue to be under pressure. "It would also give an official EU imprimatur on Europe's dirty secret: public treasuries will do anything to make private bank creditors whole. Committing this mistake to stop the contagion of panic in government debt will only make it worse. Propping up banks whose losses have still not been fully realised cannot possibly improve sovereign creditworthiness" (FT Editorial, November 15, 2010).

3. Missing in the Commission Package: Establishment of a Crisis Solution Mechanism

a) The European Monetary Fund and the Position of the European Parliament

What has certainly been missing within the proposals by the EU Commission in order to make the whole package of governance reform complete and workable is the scheduled *establishment of a crisis solution mechanism*. However, this lack seems to be resolved by the agreements reached at the October 28–29 EU Council.

In accordance with *Feio* (2010), this paper argues that one should "establish a permanent mechanism or body (a European Monetary Fund), after due examination of its pros and cons, which should not take more than one year, to be an overseer of sovereign debt developments and to complement the SGP as a mechanism of last resort for cases in which market financing is no longer available for a government and/or member state exposed to balance of payments problems; it shall be based on existing mechanisms (the European Financial Stability Facility, the European financial stabilisation mechanism and the European balance of payments assistance instrument) and shall include clear rules inter alia on the following aspects: a) membership criteria, such as fulfilling the minimum requirements for national budgetary rules/institutions, b) decision-making procedures and funding, c) conditionality for exceptional loans, d) monitoring and e) resources and powers; such a mechanism should not limit the powers of the budgetary authorities to establish the EU budget at an appropriate level, should avoid moral hazard and be consistent with state aid principles and the consequences of ignoring them." This paper later on checks whether these conditions are fulfilled in case of the EMF.

The crisis solution mechanism must not necessarily take the form of an EMF but could in principle also consist of a *Sovereign Debt Restructuring Mechanism* (SDRM) à la IMF (*Krueger* (2002); *Rogoff/Zettelmeyer* (2002a, b)) which was originally designed to cope with defaults of emerging market countries such as Argentina. But the facts that (a) the

SDRM seems to take more a (softer) role of a "judge" between creditors and debtors and (b) there is a legal vacuum how to organize orderly and unscheduled default in the euro area (in contrast to the detailed descriptions underlying international bonds issued by emerging market countries which have been addressed by the SDRM point at the necessity of installing an EMF.

b) EMF Substituting ECB as the Bad Bank for the Euro Area

A European Monetary Fund according to the model designed by Daniel Gros and Thomas Mayer might well represent the blueprint of an orderly sovereign default mechanism which really deserves its name (*Gros/Mayer* (2010a)). It would contribute decisively to release the ECB from her role as a bad bank and to let the debtor countries and the creditors participate in the costs of sovereign default according to the costs-by-cause principle. Otherwise, the reputation of the ECB would be damaged too much and one would slip deeper and deeper into a transfer union.

Even more important from a strategic point of view, an EMF does not systematically discriminate against smaller countries and takes away any German-French dominance from the mechanism (smaller countries complained about both issues after Deauville). An IMF mitigates the currently increasing tensions between larger and smaller member countries, the latter feeling patronized by the former. This is because every member country would, according to the envisaged financing mechanism, be called to account proportionally to its GDP if it breaches the Maastricht fiscal criteria. However, its probability of realisation could be larger if it would not be seen as a competitor of the IMF on an international level and especially so by US officials (for a deeper discussion of the IMF-EMF relationship see *Belke* (2010)).

c) Status Quo Only Moves the Day of Reckoning

The results of the October 28–29 EU summit suggest that politicians finally realized that unlimited financing of insolvency-prone countries and banks will not be tenable any more. This change of mind constitutes the ultimate merit of the agreements made during the summit. Any hardening of the SGP could be unlimitedly pursued and are welcome as a complement to an EMF.

But independent on whether the rules are endowed with sanctions or not and on the case costs-by-cause principle, the costs of avoiding default still accrue in any to the community of the remaining member states. The default-prone governments still keep their threat potential since their default would cause systemic costs which are generally perceived as prohibitively high. What is more, the solvency of the saviour countries has to be safeguarded which tends to increase the costs in cascades.

Seen on the whole, thus, the status quo has not been an effective solution for insolvent debtors; it merely frontloaded the day of final reckoning to some day in the future. In addition, it makes debtor countries hooked on it. Since access to the ECB's ordinary monetary policy operations is the cheapest way of refinancing, the distressed banks will even steadily increase their dependence from this source (*Gros* (2010b)). This process will finally lead to a concentration of bad risks on the ECB balance sheet as described in detail in *Belke* (2010).

The ECB and the EFSF have assumed the allocation function of capital markets, since they decide in a completely discretionary manner which countries and which banks are granted access to (re-)financing at which costs.

d) The European Monetary Fund: A Preferable Blueprint

Let me now briefly elaborate on how to interpret the EMF proposal by Gros and Mayer which incorporates many elements not included in the EU Commission package but is in strong compliance with *Feio* (2010) (*Belke* (2010a); *Gros/Mayer* (2010)).

Pre-empting the end game, i.e. recognize sovereign default as "ultima ratio" for a country in financial distress, and *limiting moral hazard of debtors and creditors* by charging the former for excessive deficits and debt and imposing haircuts on the latter for imprudent lending are among the *key goals* of a European Monetary (Stability) Fund. In this respect, the EMF proposal is in accordance with *Feio* (2010) ("such a mechanism should ... avoid moral hazard ...").

The *key principles* of the EMF are as follows. It allows sovereign default at minimal cost in terms of systemic stability and public expense. It puts a floor under the market price of debt in default through guarantees and/or debt exchange. This floor contains contagion as the downside for debt of other countries is also limited (note that Spain's public debt share at GDP amounted not more than 60 percent at the start of the debt crisis). Concerning haircuts, the nominal value of debt after the haircut shall amount to 60 % of GDP of the defaulting country. The idea is that telling markets what the haircut will be would keep the defaulted bonds tradeable in secondary markets and prevent complete market chaos. And what is the benefit to the creditors? The only alternative for a private creditor would be a much bigger haircut. Gros and Mayer think of GDP warrants to align the interests of creditors and debtors. Since the EMF might become the sole or at least the principal creditor of the defaulting country (directly through exchange or indirectly through guarantee) the political leverage of EU framework can be applied to discipline the "debt sinners" (*Belke* (2010 a); *Gros/Mayer* (2010)).

e) Problems with EMF Debt Workout, Stage II

The fact that in the future *private creditors will take a share in the costs of a default* is believed to be the main trigger for panic spreading on the markets in the previous two weeks. The EU heads of state have already decided that it will end up like that. Until their next summit in December 2010 proposals shall be available *how* this will be managed in the time after mid-2013 when the current rescue package will run out. The uncertainty about what will happen thereafter, the fear to be asked to pay up before that date and that collective-action clauses are still in the debate are making investors extremely nervous.

What is more, financial market actors could speculate against a country as soon as the expectation manifests itself that it will utilize the crisis mechanism. Some even argue that the crisis would be even caused by these linkages. Also the banking system of the default-prone country might "collapse" since it is dependent on government guarantees. The social and political consequences of such a development are incalculable. In the end, exactly the opposite of the original intentions would be reached: speculative investors would take advantage of the current situation while many small savers suffer damage. Over the previous days investors have already withdrawn their money from endangered countries like Ireland und Portugal (*Bini Smaghi* (2010)).

However, this view appears to be overly pessimistic because the available academic literature on the effects of creating a sovereign-debt resolution mechanism on bond yields tells us that the introduction of rules (with the involvement of creditors) for coping with sovereign default will corroborate the inclination of markets to differentiate between high and low quality borrowers and to evaluate loans and bonds accordingly. An insightful study in this respect is *Eichengreen/Mody* (2004) who examine the implications of including collective-action clauses in loan contracts for borrowing costs. For a sample of some 2,000 international bonds, they compare the spreads on bonds subject to UK governing law which typically include *collective-action clauses,* with spreads on bonds subject to US law, which do not. Contrary to the assertions of some market participants, they find that collective-action clauses in fact *reduce* the cost of borrowing for *more credit-worthy* issuers who appear to benefit from the ability to avail themselves of an orderly restructuring process. In contrast, *less credit-worthy* issuers pay *higher spreads*. They conjecture that for less credit-worthy borrowers the advantages of orderly restructuring are *offset by the moral hazard and default risk* associated with the presence of renegotiation-friendly loan provisions.

Without much ado a straightforward implication would *ceteris paribus* be for the euro area that the introduction of rules for dealing with sovereign default would reinforce market discipline and support "the goal of sustainable public finances laid down in the European Treaty, and thereby to the sustainability of the euro itself" (*Gianviti* et al. (2010)). However, current and future research should urgently focus on the *applicability of the ceteris paribus clause*. As mentioned in section 1, there appears, for instance, to be a legal vacuum how to organize both orderly and unscheduled default in the euro area (in contrast to the detailed descriptions underlying international bonds issued by emerging market countries). Moreover, empirical results by *Bradley* et al. (2010) indicate that the judicial injection of uncertainty into the meaning of crucial contract terms is priced by capital market participants in a predictable way. Decisions that increase the risk of repayment by sovereigns raise the rate return sovereigns must pay in order to attract international capital. Decisions that reduce this risk, in turn, tend to lower the cost of capital that sovereigns face. At first glance, this might contradict the findings by *Eichengreen/Mody* (2004). However, the main question to be answered in this context is, of course, whether the introduction of rules for dealing with sovereign default enhances or lowers uncertainty about repayment.

A second argument against the (pessimistic) Bini Smaghi view might be that the new European crisis resolution mechanism could be *designed* in a way that private creditors would not have any reason to panic. For instance, the new crisis resolution mechanism could be formulated in a way that it is *not applicable to old debt but only to new credit* from mid-2013 on. Such kind of a solution would correspond to suggestions put forward by Germany's finance minister Mr. Schaeuble: as soon as a country gets into payment difficulties, an austerity and stabilization programme will be activated – just like in spring this year in the case of Greece. As a first step, the *maturity of those bonds could be prolonged* which become due within this critical phase. If this is not effective, private creditors would have to accept haircuts on their claims as a second step. In return, they would be granted guarantees on the remaining parts (both measures are also main ingredients of the EMF proposal).

Involvement of private creditor participation is, for instance, also supported by Bruegel (see *Gianviti* et al. (2010)) and the German Council of Economic Advisors (*Sachverständigenrat* (2010)). Bruegel recommends that euro area countries should be allowed to issue new bonds only if a fixed crisis resolution mechanism including an involvement of private creditors is in place. The German Council of Economic Advisors even goes a step further. It proposes that private creditors should participate in a stabilisation programme if the EU Commission has proposed sanctions against a deficit country. This proposal refers to countries which have actively offended the rules of the SGP but not to governments which got into payment difficulties through no fault of their own, for instance, by a financial crisis. Whereas the more general line of Bruegel deserves support, the latter recommendation might go too far. It appears to be too early to involve private creditors before payment difficulties have occurred. Moreover, for all practical purposes it turns out rather difficult to distinguish whether a country got into distress through no fault or fault of their own. Seen on the whole, thus, this paper argues that private creditors should (be forced to) take into account (by an incentive structure like the EMF) that a solvency problem postponed is a problem made intractable and that it is better to make a painful break than draw out the agony.

f) EMF: Further Caveats

The remaining caveats with respect to the EMF proposal are both related to the EMF's "trigger of debt workout stage 2" issue. Another open flank of the EMF proposal consists of the fact that it is not clear up to now how and whether to treat countries suffering distress due to excessive private and public consumption (e. g., Greece) differently within the debt workout scheme than countries whose budgetary stance suffers from collapsing banks (e.g., Ireland). Finally, the issue of how much authority creditors like the EMF have over the future stance of the primary surplus and, hence, the extent of austerity in the first period after restructuring still remains critical. This is because the rewards to the government's taxing authority depend on the quality of institutions and the citizens' allegiance which in turn is related to sound principles of democracy (*Gianviti* et al. (2010); *Raffer* (1990)). These are truly decisive questions, also addressing the proponents of an otherwise preferable EMF-type solution.

V. Is an EMF a Realistic Option? Perspectives after the EU Summit

How large is the probability that something like an EMF will substitute the current 750-billion euro rescue package? Or is this issue put on the cold storage or even procrastinated? The facts point at a high probability that this issue will be decided upon in the near future. The Germans have made a package (deal) between the prolongation of the current mechanism which will run out in 2013 and the decision about a new follow-up system. The willingness of France to talk about a Treaty change is strikingly new. But Germany and France might have underestimated the fact that there are 27 national governments within the EU and one needs the support of each of them. As could be observed, for instance, at the October 28–29 EU Summit, this will be a hard way to go. From a purely legal perspective, there are only a few changes in paragraphs necessary. However, these changes have to be supported by 27 governments and have to pass the parliaments and potentially even referenda.

Moreover, as already argued above, the EMF's probability of realisation could be larger if it were not be seen as a competitor of the IMF on an international level and especially so from the US. Will there be enough political leadership to cope with implicit US pressure with an eye on the fact that IMF involvement is not explicitly dealt with in the Commission package (section 2)? At the same time it can be shown that the IMF and the EMF can well co-exist (see section on the EMF in this paper).

Our considerations in the section on "EMF – legal issues" have demonstrated that a slight change in Art. 122 should be enough to satisfy the German Constitutional Court and at the same time provide a solid legal basis for the "new post-2013 permanent EFSF" (*Gros/ó Broin/Kaczyński*

(2010)) which will probably not be explicitly referred to in any Treaty changes. The new mechanism could then probably be developed and made effective on an intergovernmental basis. In case of too much resistance against an EMF as such, it might not necessarily involve the creation of a new institution. Instead, it could take the form of an emergency financing mechanism which is run by the EU Council. Its activation would, however, for political reasons necessitate unanimity as is the case in the existing EFSF (*Gros/ó Broin/Kaczyński* (2010)).

The October 28–29 2010 EU summit agreement on a limited Treaty change gave some limited leeway for deciding about the important details of the new "permanent EFSF". Given that only a few weeks remained until the next European Council meeting in December and with an eye on the fact that any solution will hinge on Germany's financial contribution, it appeared at that time not unlikely that we would see a mere prolongation of the EFSF but with new livery. So, at the time of writing my Briefing Paper for the European Parliament in November 2010, I finally bought the view taken by *Gros/ó Broin/Kaczyński* (2010) that "the new permanent EFSF" would be of a rather *light structure,* probably resembling a "Berlin Club" as it was discussed in October and November 2010 in German government circles. The task now is to design this structure in such a way as to allow for an orderly sovereign default including the participation of private creditors mentioned in the Council Conclusions. As mentioned above, this is likely to be the most difficult part of the new mechanism. Some first sound proposals in that direction can be found in *Gianviti* et al. (2010).

Finally, some stylized facts stand out. First, it seems as if the inclusion of collective-action clauses (CACs) in sovereign bond contracts is target-aimed. Since banks are de facto under government control, gaining a creditor share of 75 percent does not appear to be out of reach in the case of the euro area. Second, a free-will commitment of large investors to stick to and continue to hold their investments in euro area sovereign bonds also in times of crisis is no incentive-compatible and full-fledged alternative. Seen on the whole, thus, the looming institutional follow-up to the EFSF framework does not differ too much from the EMF proposal.

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Summary

Reinforcing EU Governance in Times of Crisis
The Commission Proposals and Beyond

The extensive package proposed by the Commission on September 29, 2010, is the most comprehensive reinforcement of economic governance in the EU and the euro area since the launch of the Economic and Monetary Union. Broader and enhanced surveillance of fiscal policies, but also macroeconomic policies and structural reforms are sought in the light of the shortcomings of the existing legislation. New enforcement mechanisms are foreseen for non-compliant Member States.

In this very crucial and important package of 6 legislative dossiers this paper tries to identify critical missing or redundant and/or unworkable elements within the Commission package. Moreover, it checks what (if anything) is missing outside and beyond the proposals in order to make the whole package of governance reform complete and workable as, for instance, crisis resolution mechanisms and debt restructuring, EMF, project bonds and Eurobonds. (E61, E62, F55, P48)

Zusammenfassung

Stärkung der „EU Governance" in der Krise:
Die Kommissionsvorschläge und darüber hinaus

Das am 29. September 2010 von der Europäischen Kommission vorgestellte und dem Europäischen Parlament vorgelegte ausführliche Maßnahmenpaket stellt die umfassendste Verstärkung einer europäischen „Economic Governance" seit Einführung der Wirtschafts- und Währungsunion dar. Angesichts der Mängel in der

existierenden Gesetzgebung werden dabei eine weiterreichende und verbesserte Überwachung der Fiskalpolitiken, aber auch makroökonomischer Politiken sowie Strukturreformen angestrebt. Neue Durchsetzungsmechanismen für Mitgliedstaaten, die gegen die Regeln handeln, sind geplant. Im Hinblick auf das sehr wichtige und entscheidende Paket der Kommission, das 6 Gesetzes-Dossiers umfasst, wird in diesem Beitrag versucht, fehlende oder überflüssige und/oder gar nicht verwendbare Elemente zu identifizieren. Weiterhin wird überprüft, was (wenn überhaupt) außerhalb und über diese Vorschläge hinaus noch fehlt, um das gesamte Paket der Governance-Reformen vollständig und praktikabel zu machen. Dies können potenziell Mechanismen zur Krisenlösung und Umschuldung, ein Europäischer Währungsfonds, Projekt-Bonds und/oder Euro-Bonds sein.