CLOSING THE GAPS OF THE SGP.
WHY A SOVEREIGN DEBT RESTRUCTURING MECHANISM?
REFLECTIONS FROM A POLITICAL ECONOMY PERSPECTIVE

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1 Motivation

The agreements reached by the European Heads of State or Government at their recent summits and the succeeding implementation steps have caused intense public discussions. The crucial question is if the tools developed under the new EU coordination framework, including the fiscal compact, provide a comprehensive answer in resolving the major economic and fiscal crisis in the euro area or if major conceptual issues remain which could lead to a prolongation of the current turbulences. One major flaw is still evident and will be of great influence. The summits did not answer the crucial question whether there is a bail out or not; markets will further speculate on the answer.

At the same time the current debate reflects fundamental misperceptions of the political economy of the EU economic and fiscal governance. This raises the question of how to address the possible conceptual shortcomings.

In this essay we explore what we see as major structural gaps or black holes of the SGP architecture and of the macro/microeconomic governance and we propose as a vital complement to the current (reformed) framework a comprehensive sovereign debt restructuring mechanism. We clearly offer the following view: there will be no solution without a clear perspective concerning bail-outs and an insolvency scheme or full joint commitment for all sovereign debt. And we also clearly expect that the latter alternative brings us into a state of the union of a quite different kind with very dangerous economic, political and legal pitfalls.

We derive our conclusions from a political economy perspective as we focus mainly on the institutional side of the EU governance. In a way, we contrast the ongoing real time politics with an ideal-type view or blueprint idea, as the German sociologist Max Weber once put it. Furthermore, if we want to break new ground and get a full picture of the European Scenery, we have to know where we come from – historically and institutionally. Having been involved in all the stages of SGP development and reform starting from the late nineties and during the last decade, we start with a reflection of the history of the SGP from the very beginning until the current crisis.

When assessing the current reform package labelled SGP 3.0 based on quite reasonable proposals by the European Commission, we turn the screw of these ideas slightly further and focus on structural gaps which have not been closed by the current reform, not even by the fiscal compact from December 2011. We refer to important fiscal governance elements that were under discussion in the European arena in recent years. We also assess the fiscal and economic governance elements which have been laid down in the current 6-pack (plus fiscal compact) with a plea for an integrated approach.

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Disclaimer: The current paper offers their personal view, not necessarily the view of the ministry or of any other person. We thank the participants of the Banca d'Italia Workshop on Fiscal Rules, 29 March-2 April, 2011 in Perugia, and in particular to Daniele Franco, George Kopits, Vitor Gaspar, Sebastian Barnes, Kai Konrad, Marc Hallerberg and William Brunton for discussions of the subject.

Derived from the severe shortcomings of the whole governance architecture, the debt restructuring issue brings an additional dimension into play: a comprehensive approach with an orderly use of market forces and the systematic involvement of private actors beyond the political process. The basic ingredients for such a complementary framework will be compared with the current ESM consensus from a political economy or public choice perspective.

2 From SGP 1.0 to the sovereign debt crisis

In order to reach a full understanding of the underlying problem structure of the current economic and fiscal developments in the present institutional setting, it is sometimes wise to reflect historically where one comes from, the fundamental ideas and different stages of the evolution of the SGP framework and the specific reasons for the respective institutional set-up.[1]

2.1 The invention of SGP

The well known basic premise of the original Stability- and Growth-Pact for the nineties relied on the conviction that the independent monetary policy of the ECB has to be and can be complemented by a political process of controlling public finances and of indirectly fostering convergence in the euro area – without leading to a "gouvernment economique". That philosophy implied that the prevention and correction of unsound fiscal (and economic) developments depends exclusively on the effectiveness of cooperative political institutions, processes and actors.

In substance, the Pact in its "premature" state of the art at that time focussed on the current deficit, the 3 per cent ceiling in the famous dictum of the former German finance minister Theo Waigel: "3.0 is 3.0". What was meant by that saying is the presumption that a clear and undisputable focus on the deficit is necessary and sufficient to ensure sound public finances in the euro area. Although the 60 per cent public debt criteria was already mentioned in the Maastricht Treaty, there was a general consensus that – under certain then realistic assumptions for GDP growth and interest rates – respecting the deficit criteria would automatically lead to a convergence of the public debt level below 60 per cent. Although scientific literature already had developed the concept of fiscal sustainability,[2] there was no sense for or focus on fiscal sustainability in the fiscal policy debate.

Nevertheless, what was rooted in the expectations of political stakeholders at that time – particularly on the German side – was the conviction that beyond the institutionalized political pressure of the Pact, market forces expressed by interest rate spreads would continue to do their job and create sufficient complementary incentives to discipline the fiscal policy of politicians. It turned out that this ambition was not met by reality, on the contrary, a strong convergence of interest rates in the currency union occurred in the run-up to EMU. In addition to "false" exchange rate relations specified for entry to the EMU, that under-pricing of risks[3] weakened the stabilizing effect of an exclusively politically steered SGP process.

The lesson to be learned from that history is that the narrow focus on the public deficit and the dependency of a full functioning political process with a "blackout" of disciplining market forces were key issues in the early phase of the SGP which must be addressed in the subsequent reform periods. And, it should not be forgotten that the issue of sustainable economic development

1 See, e.g., EU COM (2011), Van den Noord *et al.* (2008), and Heipertz/Verdun (2011).

2 See the seminal paper by Blanchard *et al.* (1990).

3 See, recently, OECD (2010). That unsound development was countered later by an overshooting on the upside.

Table 1

Public Finance in EMU
(public deficit, percent of GDP)

Country	**97-01**	**2002-06**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**
Belgium	–0.7	–0.6	–0.3	–1.3	–5.8	–4.1	–3.6	–4.6	–4.5
Germany	–1.7	–3.3	0.2	–0.1	–3.2	–4.3	–1.3	–1.0	–0.7
Ireland	2.4	1.2	0.1	–7.3	–14.2	–11.7	–10.3	–8.6	–7.8
Greece	–4.2	–5.9	–6.5	–9.8	–15.8	–10.6	–8.9	–7.0	–6.8
Spain	–1.9	0.6	1.9	–4.5	–11.2	–9.3	–6.6	–5.9	–5.3
France	–2.2	–3.2	–2.7	–3.3	–7.5	–7.1	–5.8	–5.3	–5.1
Italy	–2.3	–3.6	–1.6	–2.7	–5.4	–4.6	–4.0	–2.3	–1.2
Portugal	–3.3	–3.9	–3.1	–3.6	–10.1	–9.8	–5.8	–4.5	–3.2
Hungary	–5.3	–8.0	–5.1	–3.7	–4.6	–4.2	3.6	–2.8	–3.7
Sweden	1.0	0.6	3.6	2.2	–0.7	0.2	0.9	0.7	0.9

Source: EU Commission, Autumn Forecast 2011.

leading to a convergence of the euro are economies was more or less taken for granted, there did not exist a serious coordination framework to ensure this.

2.2 The SGP reform 2003/05

Triggered by Excessive Deficit Procedures against Germany and France from 2001 onwards, the launch of the SGP reform brought indeed some progress on the conceptual side. The so-called SGP 2.0 was clearly less simple and mechanistic compared to the original start-up: the whole surveillance process was refreshed and departed to a certain degree from the simplistic 3.0 per cent dogma. Specifically and in addition to the Maastricht reference value, the dimension of sustainability was systematically incorporated in the preventive arm of the Pact leading to a safety margin by shifting the medium term objective close to or above surplus. On the other hand, the fiscal impact of structural reforms was to a certain extent included in the corrective arm, and more transparent consolidation paths (0.5 per cent-points per year) were defined. Not covered in the sustainability and public debt assessment were implicit liabilities or implicit debt.

The other side of the coin, however, was that the institutional backing and the incentive structure of the SGP were improved only partially or even weakened by the “original sin” of the Franco-German case. The enforcement of the Pact based on hard political sanctions remained as an overarching principle. In that sense the power and credibility of the Pact relied totally on the strength and effectiveness of the political process, an idea that was simply proven wrong after 2001. As the former chief economist of the ECB, Otmar Issing, criticized sharply, the reform caused severe political losses which outweigh the conceptual improvements. From a political economy view, it is indeed this dependence of the functionality of the Pact on a political process which represents the Achilles heel of the whole fiscal coordination architecture.

2.3 Remaining gaps and missing links to economic governance

Beyond the institutional shortcomings severe conceptual gaps and undiscovered areas remained: the concept of the Pact at that time oaid no attention to (sovereign) debt risk, the debt criterion remained more or less untouched. Obvious malfunctions of the markets were not addressed. Driven by the hope that different interest rates paid by the currency's members are a sufficient incentive for prudent fiscal policies, *i.e.*, SGP plus markets work, the possibility of market distortions and non-linearities was not recognized. The reality was that, until recently, there were no spreads emerging at all, rooted in a public bail-out belief which could not be encountered by the political stakeholders.

A further conceptual issue was that, although fiscal institutions matter a lot, they were not prominently highlighted in the Pact. The academic debate and the international institutions, EU Commission, OECD and IMF, focussed in recent years on the exchange of best practices regarding the supporting role of institutions for an effective enforcement of fiscal rules. The Pact itself, however, was blind with respect to the national institutional setup.

Moving beyond the mere public finance dimension, a missing link from the SGP to economic governance has to be recognized. Although complementary coordination mechanisms were developed, they had never been devoted to the issue of euro area coherence or systematically linked to each other. Economic governance as the second major arm of coordination in Europe started from scratch and it took some years for the so-called Broad Economic Policy Guidelines, the major coordination tool, to develop – and it evolved in the wrong direction, economically and institutionally. Economically, the focus on growth and competitiveness of Europe as a whole against rest of the world neglected economic disparities or unsustainable developments with the common currency area. Institutionally, squeezed by the heterogeneous interests of the political and bureaucratic actors, a "Christmas Tree" evolved, meaning that a focus on growth and employment, which could function as links to the Pact, could not be produced. And departing from the political platform of the Lisbon Strategy of the year 2000, the Mid-Term Review in 2005 with a final relaunch via the EU 2020-Strategy delivered only insufficient improvement. At least it can be said that the tools of Integrated Guidelines and National Reform Programmes were able to streamline the processes.

Regarding enforcement, the Treaty based BEPGs were even weaker and, as history showed, never focussed on problematic developments. In addition, there was no systematic macro/micro „check" incorporated in the system, for example in form of a competitiveness review or in form of an assessment of the fiscal impact of structural reforms. And we have to keep in mind that we still lived in a pre-crisis world, Greece was not on the institutional radar at all, although it had already materialized in substance.

3 Sovereign debt crisis changes the picture

After the financial markets crisis and the real economy crisis, the Sovereign Debt Crisis (Crisis 3.0) changed the picture dramatically and revealed additional major gaps in the whole governance architecture. As documented in the historical analysis by Reinhart/Rogoff,[4] the

4 Reinhart/Rogoff (2009).

Sovereign Debt Crisis typically emerges from a crisis of financial markets and real markets and it spreads quickly.

Despite that empirical wisdom, the political stakeholders and also the political economists never imagined that a sovereign debt crisis in a relatively small country could affect the entire Eurozone and weaken confidence in the common currency. Indeed, it was a fact that after the limits of rational markets became visible during the financial and banking crisis in 2008, market beliefs shifted 180 degrees and led to an overshooting of spreads on the upside (today Spain faces a spread more or less equal to North Korea). And it is for the accumulation of systemic risks, the risk that one country's debt crisis will prove contagious for the collective area as a whole, that the SGP without complementary support fails to function as an adequate provision and that we end up with a total bail-out.

That does not mean that governments do not need the markets. On the contrary: we will not find a permanent solution to the Euro zone problems if we cancel out the function served by interest rates signals. This market instrument forces countries, parliaments and governments to take the necessary decisions and reduce incentives for pursuing poor policies indefinitely. Nevertheless, we face a new conceptual problem dimension in the sense that at the end of a political process – represented by the preventive and corrective arm of the SGP - the process does not stop and that the (economic/fiscal) process is not under control.

The strategic question is then: in our attempt to remedy the system, should we still rely totally on the strength of the political coordination framework or should we complement an improved political process (SGP+) with a systematic and institutionalized use of market forces as a disciplinary instrument, *i.e.*, to force governments to do the right things early and comprehensively. One should be reminded that regarding the private sector, there was no monitoring of private bank debt, no clear mechanism for bank failure and inadequate financial market supervision and regulation.

The question of what a systemic response could look like was answered by the real political process. In 2010 time for crisis management was running out quickly, and what followed was mere ad-hoc or piecemeal engineering. Partly, the rescue packages and day-to-day solutions were a natural reflection of the pressing short term-problems which were occurring. Therefore, the creation of the EFSM and the further evolvement of the EFSF were thoroughly necessary steps towards stabilising the situation.

Nevertheless, history demonstrated quite vigorously that such structural weaknesses of a coordination framework cannot be fixed by ordinary measures. In a sense, one could argue that short-term solutions may even turn out to be dangerous precedents as they obstruct the view to the underlying systemic problems and politically they block the requested comprehensive response. We face a clear political lock-in situation.

4 SGP 3.0 – Promising start for problem resolution but more to be done

As the political negotiations on the SGP approached the final stretch we nevertheless enjoyed clear improvements which partly resolve some open issues mentioned above.

4.1 New elements of the Pact and remaining issues

In substance, the public debt criterion now is much more in the focus. It has become a transparent and politically sanctionable reference value. In future, it will not only be obligatory to

Figure 1

New Fiscal and Economic Surveillance System

OVERVIEW

More effective Stability and Growth Pact	• In future, it will not only be obligatory to comply with the deficit criterion (ratio of new debt to gross domestic product (GDP) below 3 per cent) under the Stability and Growth Pact, but also the debt criterion (ratio of total debt to GDP below 60 per cent). • Obligatory reduction of debt: reduction in difference between debt and reference value of 60 per cent of GDP by 1/20 each year.
Earlier sanctions	Introduction of a sanction mechanism for the euro countries in the "preventive arm" of the Stability and Growth Pact (if public deficit is less than 3 per cent of GDP): obligation to ensure that budget is close to balance/in surplus.
More rapid sanctions	Reform of the sanction mechanism in the "corrective arm" or the Stability and Growth Pact (if deficit is greater than 3 per cent of GDP and/or insufficient action has been taken to reduce debt): sanctions are triggered more rapidly for the euro countries.
More comprehensive sanctions	Not only can financial penalties and fines be imposed, in future a Member's EU funding could be cut far more than previously. This would mean a stronger linkage of payments from certain EU funds to sustainable fiscal policies than in the past.
European Semester	National planning and reporting cycles will be synchronised in the "European Year": the Member States' budgetary and structural policies will be reviewed over a period of 6 months to identify inconsistencies and emerging imbalances.
New Surveillance Procedure	New procedure for the surveillance and correction of macroeconomic imbalances with concentration on Member States that are running large current account deficits and have lost competitiveness.

comply with the deficit criterion but also with the debt criterion (ratio of total debt to GDP below 60 per cent). The balanced budget will become compulsory and be backed up with sanctions over the medium term. A violation of the deficit criterion and/or insufficient action to reduce debt leads to an EDP and can in the end lead to sanctions under the new regime. The agreed correction path leads to the obligation to reduce excessive debt, defined as the difference between actual debt level and the 60 per cent-reference value, by 1/20 each year.

On the institutional side we can expect – at least on paper – a better and quicker enforcement via quasi-automatic sanctions. In the "corrective arm" of the Pact sanctions are triggered more rapidly for the euro countries. Not only can financial penalties and fines be imposed, in the future a Member's EU comprehensive funding can be cut far more than previously. This would mean a stronger linkage of payments from certain EU funds to sustainable fiscal policies than in the past.

Most important, the overruling power of the Council is to a certain extent blocked. But that necessitates that the EU Commission now takes its responsibility as guardian of the Treaty seriously, which was in the past not always the case and which can be doubted for the future. Also fiscal institutions are now more prominent, although the conceptual role and the legal status are still to be developed further. These developments are all fine, but it should be seen that there are quite substantive agenda points not settled yet.

One important element is an even more ambitious shift of the SGP anchor (MTO) to surplus as the fiscal impact of the ageing societies calls for a much more prudent safety margin against these developments and in order to increase the resilience of public budgets against future shocks.

As recent analysis by Deutsche Bank Research reveals, the major economies in the world will face a dramatic pressure on public debt, even under a scenario where significant budget consolidation following the current SGP rules is implemented. The quite substantive risk factors and the fiscal sustainability problems will add up to an upward pressure on public debt that can hardly been controlled by merely reaching a balanced budget. Rather, what is necessary are significant primary surpluses. Furthermore, the upward pressure is triggered by the fact that there is no containing effect in the economic upswing. What was conceptually healed in Germany by the introduction of a cyclically adjusted MTO,[5] is unfortunately not implemented in Europe in a real credible manner. These empirical finding should therefore translate into the set-up of the MTOs and the enforcement of the MTOs over the cycle.

There are experts who argue that this kind of tough fiscal consolidation, a smaller public sector and austerity as a paradigm (together with a competitiveness fetish) will lead to a decrease in consumption in these countries in the immediate future and therefore to negative macroeconomic spillovers for the euro area as a whole. We would rather argue that an increase in consumer and investor and financial markets confidence and a shortening of unemployment lines will in the medium term cancel out by far any possible short-term dip of consumption. It will take time before these efforts will bear fruit and the situation normalise. But not consolidating, not sticking to such tough MTOs and reforming now would be much worse and would undermine confidence in the crisis countries and the Euro area even more.

The second remaining major reform element is the revival of the “quality of public finances” agenda, meaning that the link between public budgets and economic growth being systematically highlighted in the surveillance process, mirroring the issue of the (macro-)fiscal impact of structural reforms.

Starting from the year 2000, there was an ongoing debate on complementing the Pact with a process that tries to capture the growth effects of public expenditure and revenues resulting in a widely acknowledged EU initiative by Germany, Denmark and Austria, backed by the EU Commission and the Economic Policy Committee of the EU.[6]

The task in this concept is threefold: first, there is a need to assess the effects of the composition of public expenditures on sustainable growth and employment. At issue here is mainly the prioritization of expenditures as well as efficiency and effectiveness analysis, for example in the policy areas of social spending, R&D, health care and education.

Second, we have to analyze how the tax structure can contribute to sustainable growth paths. OECD[7] has done a great deal of work in that field and recent analysis shows that national tax policies were among others responsible for asset price bubbles particularly in the housing sector.[8]

5 There are still open issues, see Ebert (2012).

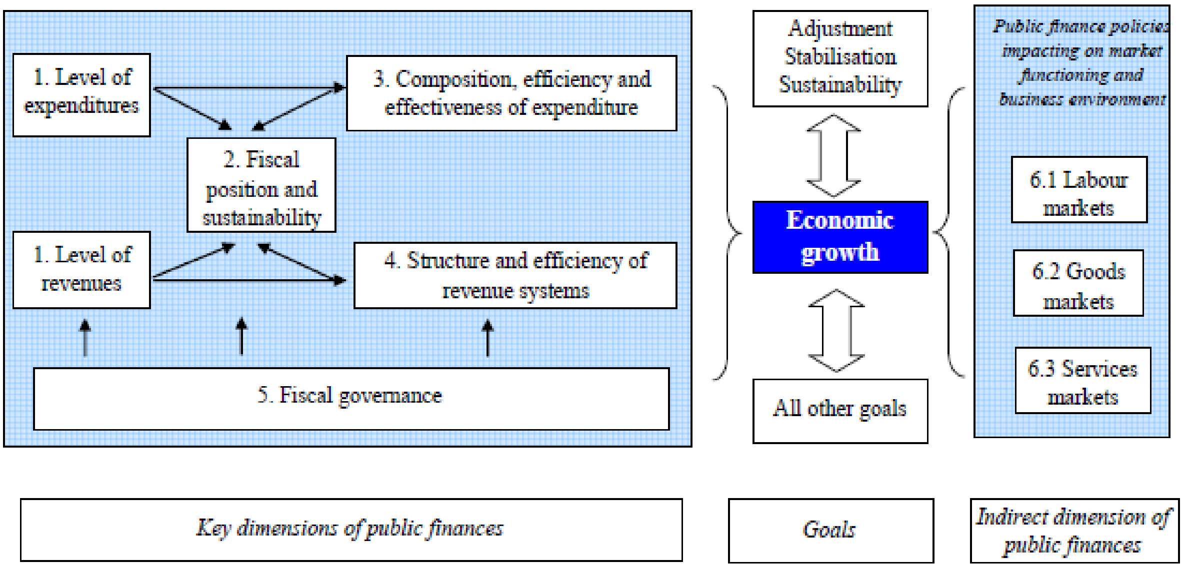
6 For a comprehensive overview see Kastrop/Deroose (2008) and Ebert (2009).

7 Heady (2007).

8 OECD (2010).

Figure 2

The Quality of Public Finances: A Multi-dimensional Framework



Source: Barrios/Schächter (2008) with further references.

Third, we have to deepen our understanding of fiscal institutions and the role of national implementation of EU type fiscal rules. We would like to point here to the experience made in Hungary, where the then independent Fiscal Council was chaired by George Kopits,[9] but also to other independent bodies, such as in the Netherlands or Sweden, which help to control public expenditure and which procedures like Top-down-Budgeting (for strength of fiscal rules and institutions, see Figure 3).

A further gap of the SGP which is only closed partly relates to the full integration and strengthening of national fiscal rules and frameworks in the Pact. As we learned, the political process under the Pact will not be sufficient to realize the necessary prudent fiscal policy path without backing by the national fiscal authorities. Therefore, to add clear procedures regarding the transfer of the European logic into national rules and institutions, as done in the case of Germany, or even amend the SGP logic with complementary framework tools is key. And the fiscal compact from December 2011 points exactly in that direction, although it is not clear yet if that transfer of institutions into national law will materialize as it was envisaged.

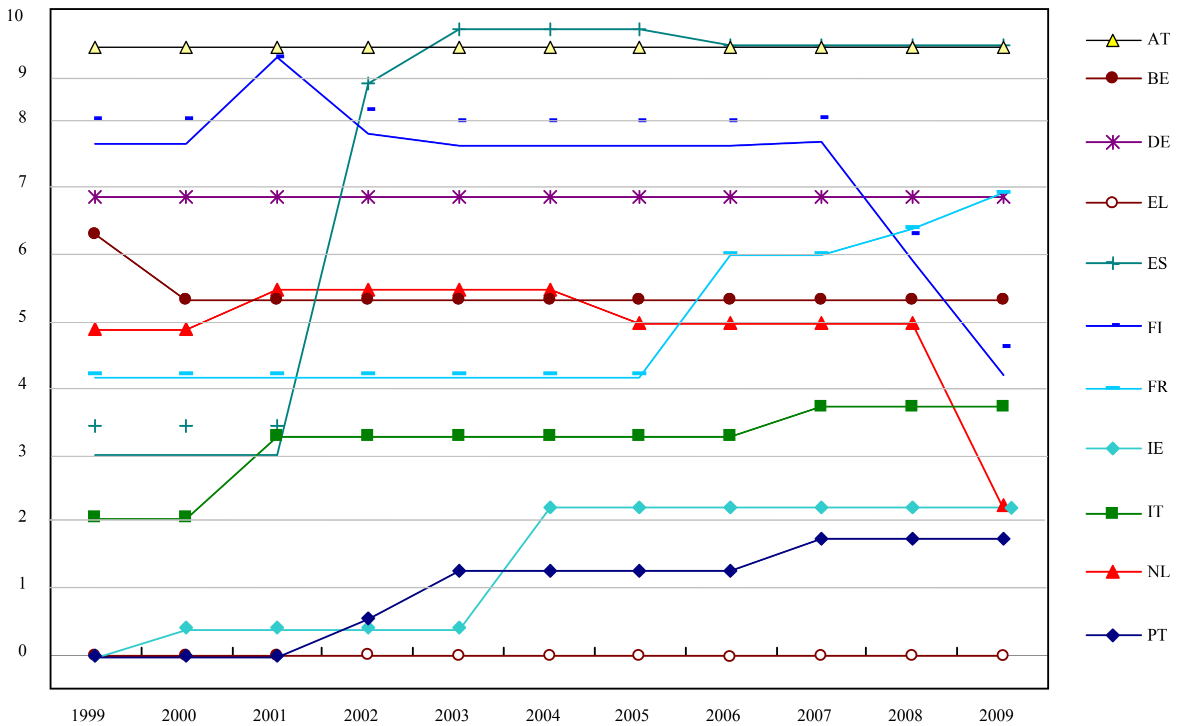
4.2 The fiscal compact

The decisions taken by the European heads of state and government on 9 December 2011 regarding a new fiscal compact represent an important step forward towards the formation of a fiscal union in the spirit of a stability union. Based on the model of Germany's constitutional debt rule which itself is based on the EU fiscal stability model, the Euro countries commit to introduce national arrangements for balanced budgets. In future, the annual cyclically adjusted deficit is not

[9] See Kopits (2012), in this volume, and the supporting Debrun/Takahashi (2011), as well as Nyikos (2012)

Figure 3

Fiscal Rule Index



Source: Iara and Wolff (2010).

allowed to exceed 0.5 per cent of GDP. This should on a long-term basis ensure that budgets are kept close to balance over the economic cycle, while fiscal policy can be counter-cyclical.

This national budget rules are supposed to strengthen the preventive arm of the SGP. The rule will be introduced into national legal systems at constitutional or equivalent level. It is planned that the European Court of Justice will control whether the new budget rules have been correctly transformed into national law. This is an entirely fresh aspect which emphasises the credibility of the fiscal compact.

Furthermore, the preventive monitoring of national budget policies will be enhanced noticeably. This goes so far as to enable the European Commission to ask a Member State to resubmit a budget. The corrective arm of the Stability and Growth Pact will be further strengthened on the basis of inter-governmental agreement. Member States under EDP are to commit to detailed consolidation and adjustment measures as part of a partnership programme, with compliance monitored by the European Commission and Council. Furthermore, sanctions imposed on Member States for exceeding the 3 per cent deficit threshold will be triggered in a more automatic way. All recommendations and decisions leading to sanctions can only be rejected by qualified majority. This introduces an automatic response that substantially limits the leeway for generous interpretation of the provisions.

The rules and obligations of the new fiscal compact should be implemented by way of primary legislation in order to strengthen their binding force; this was a particular concern of the German Government. However, as long as this step towards integration is not taken by all

27 Member States, any amendment to the treaties is impossible. Therefore, implementation is to be achieved initially via an inter-governmental treaty, with the objective of bringing it under EU law subsequently.

4.3 Integration of fiscal and economic surveillance

The experience with the unsustainable developments in some countries of the euro area, combined with unsustainable fiscal positions revealed that the economic governance in Europe cannot solely rely on a tough fiscal monitoring. What is needed instead is a systemic integration of fiscal and (macro-/micro-)economic governance in the corrective and in the preventive arm. The "New Normal" after the crisis is to put economic imbalances and unsustainable position, competitiveness questions as well as the coherence issue in the euro area and the micro-macro/fiscal link to the forefront of the surveillance process and on the political agenda.

In that philosophy, a new procedure for preventing and correcting macroeconomic imbalances has been developed, partly complementing the EU2020-Strategy and taking up a few institutional elements of the Pact (e.g., the form of an Excessive Imbalances Procedure EIP).

Not all new elements of that process can be reviewed in this paper,[10] therefore we want to focus on two issues: economically, there has been an ongoing discussion about the focus of the assessment of external imbalances, if the procedure should be applied symmetrically (current account surplus countries should also be subject to an EIP) or asymmetrically (only deficit countries are under closer surveillance). Much has been said about the economic reasoning for both sides – the pure micro pro-competitiveness view against the pure macro-view. Using some economic common sense and taking a look at the historical figures, it seems quite reasonable that a moderate (a)symmetry, for example –4/+6 per cent (plus a catching-up mark-up if appropriate) could serve as thresholds. That would give the country specificities, such as the export orientation of countries as in Germany, enough room without releasing them from co-responsibility for the coherence of the euro area as a whole. A link to the SGP in this procedure can be created if the implications of public and private debt to the stability of the euro area are addressed in the analysis. Other important issues in this context are the role of external debt, the identification of asset price bubbles and a clear focus on competitiveness in general. Widely undeveloped in this surveillance process and also in the work of the ESRB is a systematic macro-prudential supervision of financial markets in a general (macro- and micro)economic context. A lot of follow-up work on that issues will be necessary to make the picture complete.[11]

A word on the Lisbon Strategy and its follow-up, the strategy Europe 2020: Although it is economically reasonable to focus economic surveillance on competitiveness combined with macro-structural aspects, the case of Greece brings one additional dimension in the focus which has not been addressed conceptually by the European institutions. The central aim to take care of a coherent and sustainable economic development in the common currency area in principle should call for a renewed Lisbon Strategy focussed on growth and jobs – and convergence of developments. To focus this task on competitiveness, as done by the EIP, seems much too narrow in view of the immense challenges a dispersed euro area faces. Insofar the Lisbon Strategy after the Mid-term review in 2005 was right in focus; again, it lacked a constructive institutional back-up and it lacked a second stage in form of an economic union which is able to steer growth in the respective regions. The Strategy Europe 2020 with its Christmas tree approach and unclear competences is not capable to fulfil such an ambitious task.

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10 See the respective COM proposals and Ebert (2011).

11 See Pisani-Ferry, J., A. Sapir and G. Wolff (2011); and keep in mind the bad (surveillance) examples of Ireland and Iceland.

The second crucial issue, however, concerns again the institutional side. The experience of developing an economic governance under the former Art. 99, now Art. 121, of the Treaty, made clear over the last decade that, despite having reached some mutual understanding of national economic policies within the EU, it is a long way to go reaching a surveillance process which is sharp and focussed and shows the necessary bite. Until today, the processes have been diluted in a bureaucratic monster with too many stakeholders in charge, from the side of the EU Commission (where DG ECFIN lost leadership) and from the side of the Council (where ECOFIN lost its dominating role) – and it is highly improbable that the treaty based processes will in the future deliver reasonable recommendations for national economic policies or even sanctions, and that might be true even for the economic surveillance under the new macroeconomic procedure: anyway, its main task will be to focus on the problematic, unsustainable developments and to draw substantive structural recommendations which are backed by a credible enforcement technology.

The introduction of the European Semester as a formal requirement is by far not sufficient for that ambitious institutional task. Although synchronizing the national planning and reporting cycles and structural policies in the "European Year" may help to identify inconsistencies and emerging imbalances, what is really needed is the political will of the Council of the Commission to fill the new EIP with life. The first round of assessment in June 2011 was far from promising and shows a clear danger of once again diluting the process.

5 Why a sovereign debt restructuring mechanism?

The historical reflection showed that the governance architecture re is incomplete both in substance and in its institutional set-up. Now, after the reform of the SGP by the 6-Pack plus fiscal compact and the installation of the European Stability Mechanism (ESM) replacing the EFSF and EFSM from mid 2012 onwards, the crucial question comes up if these new tool are sufficient to prevent and to manage the crisis. Greece, which is now predominantly an emergency management case, is not the issue here, we focus more on the "unknown future", the possible next crisis. The task is twofold: improve the resilience of the system against a new sovereign debt crisis and minimize economic costs if an emergency case does arise.

5.1 SGP 3.0 Plus fiscal compact and new ESM – Sufficient tools to prevent and manage the crisis?

The new ESM builds upon and complements the SGP framework and the existing short-term solutions EFSF and EFSM.[12] The ESM is equipped to assist countries whose financing problems threaten the stability of the Euro area as a whole. Its toolbox consists of loans provided on condition of strict economic reform and adjustment programmes, the right to intervene in primary and secondary markets, the ability to recapitalise financial institutions of systemic importance and precautionary programmes.

The ESM is characterized by a focus on liquidity help as it is derived from the EFSF and from IMF type liquidity facilities. Even if the main purpose of the ESM is to avoid a situation in which an illiquidity develops into a state insolvency, through Collective Action Clauses (CACs) as ultima ratio-measure it provides at least basic elements for an orderly debt restructuring, should such restructuring become unavoidable.

[12] This new governance structure cannot be described in detail, for details see Schuknecht *et al.* (2011) and German Federal Ministry of Finance (2011).

One month after the ESM treaty will come into effect, CACs will be introduced in all new sovereign bond contracts of Euro area countries with maturities of more than one year. This makes allowances for the fact that the decentralized approach of CACs is becoming the predominant instrument to enable easier coordination between bondholders for a debt restructuring. They will assist in fostering an early dialogue between the debtor and the bondholders. And they hopefully will prevent individual creditors from blocking negotiations on specific debt restructuring models. Although these EURO CACs are principally based on existing CACs under UK and New York law, they have been re-modelled in order to find a distinct balance between an effective restructuring and creditor interests.

In this context, it is noteworthy that Euro zone finance ministers in March 2011 explicitly decided that an aggregation clause is to be introduced which allows an aggregation of claims across different instruments. For this to happen, a two-stage decision-making procedure with different majorities is envisaged, the result of which is binding for the outvoted minority. This restructuring-friendly approach will be counter-balanced by creditor-friendly majority rules. In particular, it is guaranteed that any decision is taken at least by a simple majority. It is also envisaged, that creditors may appoint a representative who prepares for negotiations with the debtor country.

If we look on the negative side one has to acknowledge that, analogous to the IMF toolbox, although a thorough debt sustainability analysis is the core of the decision basis, the concepts and definitions of debt sustainability are far from clear or transparent.

Its governance is politically driven and it is based on unanimous decisions, as was the rule in the SGP before the recent reform. Here the political economy mistakes of the setup of the SGP are repeated for worse. And similar to the SGP process one can question if the conditionality of the mechanism and sanctions in the case of deviation are strict enough.

Against that background the danger of moral hazard and bail out through the back door is quite realistic. The ESM set-up has a malevolent incentive structure for markets and for both, indebted and „supporting“ countries. This has fostered the public view of a looming transfer union which could indeed be a realistic alternative if one has a clear euro federal vision. But again, even in such an equalization regime, the right incentive structure would be needed, as the German system of fiscal equalization and its treatment of emergency cases demonstrate. Even in such a system we are not out of the game and maybe that bridge to such a vision is still a bit too far to cross.[13]

5.2 *Elements of a comprehensive crisis mechanism*

Under current circumstances it is in any case unavoidable that we reach a comprehensive and complementary crisis mechanism which is more than just ESM. And, as Barry Eichengreen pointed out recently, the systemic question will arise soon.

What we have to clarify is the starting position of the countries with SD-Problems, and we should always keep in mind that we do not primarily face a financial market problem rather than a structural economic and fiscal problem. A negative track record within SGP 3.0 procedures immediately leads to the question whether we are dealing with an “illiquidity or insolvency case”. Independent of the decision who conducts such an assessment, we propose that if a clear solvency case exists, managed default should be possible. This no-bail out message, which at the same time safeguards against contageon, is a favorable way of healing the disease instead of fiddling around with the symptoms.

13 See the assessment of the economic advisors at the German Ministry of Finance, WBR (2012).

In a suitable setup, we first need a tool: an independent debt sustainability analysis which clearly indicates whether we have an L or S case. Several concepts are available and could be checked for significance, for example a mix spreads, debt stock, market environment, implicit debt and other indicators. Such an evaluation could be undertaken by the ECB, the ESRB or – better – an independent Fiscal Council. We have to distinguish clearly between liquidity and solvency: we surmise that, except in special cases such as Ireland, the real problem remains the solvency issue and not transitory liquidity difficulties which can indeed be solved by EFSF/ESM.

One issue of utmost necessity should not be overlooked: it is absolutely crucial not just to think in terms of crisis resolution, but in terms of crisis prevention. Crisis tools might help resolution but can be very detrimental from a prevention point of view. Even if a mechanism would be more costly in the short term, this should be judged against the tremendous prevention effect.

So, in the end the core mechanism of the restructuring part[14] of the crisis tool box is all about incentives avoiding moral hazard and blackmail potential from markets and countries with adequate governance: decisions in principle will then be case by case. As an example, a necessary debt restructuring could include the following elements:

1) significant debt haircut (50 per cent);
2) guaranteed debt part with premium (30 per cent);[15]
3) free-floating part to test markets (20 per cent).

Case by case means a toolbox for a comprehensive ESM; while ESM is not given here there is some sense to use the existing ESM also as a "broker" for a managed default "deal" with the ingredients: CAC's, guarantees, liquidity, collateral of the country concerned where available. Default should by no means be "attractive". Therefore tough conditionalities are needed such as fees, mandatory programs, tight fiscal control and even the (partial) loss of deficit sovereignty. The other necessary side of the coin is the systematic integration of financial market regulation into the governance structure. From a public finance point of view issues like FTT are relevant here not only for getting returns but also in terms of political economy.

Important will be the governance structure of the crises mechanism – additionally to the right "set" of economic incentives. In principal there are three "governing" principles: market driven, politically driven or independent. A clever combination of all three would probably deliver best results, not only in economic terms but – what is at least of the same importance – with respect to political economy. However, it can be left open here, which specific institutional setup will serve best: options range from a loosely institutionalized but very efficient and fast setup like the London Club via an substantial extension of the ESM structure plus independent fiscal council to a formalized procedure like an Re-solvency mechanism.[16] In any case, under the current state of the European Union, a pure politically-driven mechanism/institution seems to be less favorable. The whole SGP 3.0 corrective/preventive arm and complementary measures of the fiscal compact are so far to a large extent politically driven, in decision, in commitment and even in enforcement.

If a country seeks support within a crises mechanism neither the pure market, nor the pure political solution might be feasible. Market driven would imply no political influence at all. Just political driven/enforced crises mechanism, with strong conditionality and a potential loss of certain budgetary sovereignty, would probably fuel political stress, not only in receiving but also in

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14 See also Darvas (2011).

15 See for an alternative option of a European Redemption Pact the German Council of Economic Advisors SVR (2011).

16 See, for example, Paulus (2012).

"giving" countries, when a guarantee or equivalent or at the very end tax payers money is necessary. If we stick to the ESM, the crisis management institution needs to be converged to an independent and expert driven mediator between markets, countries in trouble and the community which has to cushion the unavoidable pain and bridge the gaps. It is that reason why a political ESM should be supported strongly by a European fiscal council, which should be installed in any case as supervisor. Insofar, we go slightly beyond the scope, George Kopits has outlined for such a Council.

6 Summary and outlook

We are in the process of creating the structures for a fiscal union which in principle allows us to overcome the mismatch between monetary and fiscal policy coordination and restore public and financial market confidence. If we have a fiscal union that makes the Stability Pact more binding and enforceable, and which does the same for provisions to improve competitiveness, we could convince the public and financial markets that European Monetary Union will remain stable. Nevertheless, taking a broader and more long-term view and following the political economy reflections of the last 20 years of economic governance in Europe, there is significant room for improvement and the following ingredients of a comprehensive and systemic response are crucial to improve the resilience of the euro area system and to manage crisis in an orderly manner.

- First of all: let markets work, but of course with a clear-cut regulation and a ban on all financial activities which have clearly no positive impact on the real economy. Whether this is done by pure regulation or equity provisions of 100 per cent on certain activities or a financial transactions tax should be judged against other arguments (fiscal, locational factors, etc).
- Second: profit oriented rating agencies have to be cut off and only NGO's should deal with ratings as "consumer agencies".
- Third: full implementation of the six-pack and complementary measures such as the fiscal compact treaty (solve the legal ambiguity as soon as possible)
- Fourth: implementation of a full-fledged and partly independent crises mechanism with liquidity and solvency "arm". The ESM institution as mediator between markets, state and community, supported by an independent Fiscal Council. There is no bail-out but a rescue line which will be calibrated between all actors. Funds shall not be limited beforehand, they are created when they are needed.
- Fifth: the ECB will not be in the game, but as with any other central bank should still be the final lender of last resort in their fully given independence.
- Sixth: the fiscal strategy needs to be accompanied by an intelligent growth strategy, and that is the reason why we strongly call for a revival of the Quality of Public Finances Agenda which unfortunately had been block on the EU level by political interests. Such an agenda is conceptually clearly linked to a renewed Lisbon agenda, the new EIP and to the Pact 3.0.

Debt crisis have always been hard and costly to solve as they require significant behavioural, financial and institutional changes. A stage has been reached where countries within the Euro area have to make overdue and painful structural adjustments. We have come to a point where more solidity is the only thing that will increase confidence. To this end, we need stronger European institutions. We do not claim a European super-state rather than a new form of governance that does not just transfer certain competencies to a more central level by international treaty. The approach that the Euro zone has to take is taking limited but stringent additional steps towards a deepening of institutions, otherwise we will not succeed in equipping Europe to act in the long term. This process is underway in the Euro area and we have presented further proposals for a comprehensive solution. But what should be avoided at all cost is a disorderly default and instability and default spreading from one country to others and by that leading to a breakdown of the euro area.[17]

17 See also the reflections in Thiel (2010) and the recent, quite bold proposals by Marzinotto, Sapir and Wolff (2011).

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