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A European Stabilisation Mechanism (ESM): Salvation of the Original Sin?

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The European Union in Transition

Since 2010, the stability and viability of the European Monetary Union (EMU) has been highly vulnerable to the second-round effects of the US sub-prime crisis. The main challenge was not in the first place an attack on the exchange rate of the euro – which proved to be rather stable vis-à-vis the dollar. Instead, the challenge came as an attack on the financial viability of highly indebted countries within the EMU. In early 2010, those countries which had benefitted from the credibility of the euro until then, in particular Greece but also Portugal and Ireland, experienced a dramatic rise in the spreads of government bonds. The market for Greek government bonds totally dried up. As a consequence of the market's perception of excessive deficits, the euro's credibility was set at stake. So, European policy coordination was required: The European partners, in particular the partners in the euro area had to assist Greece that could not regain a sustainable budget on its own. This 'bilateral' assistance in fact did violate the Treaty's no-bail-out clause which for the first time would have become effective. Financial markets calmed down but temporarily. The European Council met to an urgent weekend session of May 7-9 to conclude a Financial Stabilisation

Facility (EFSF) for assistance of European governments under threat of insolvency. This enormous facility which together with IMF-assistance sums up to €750 bn, about five times the ordinary EU budget, was born under heavy pressure of international financial markets and rating agencies that had put solvency of Portugal and Spain into question. The package was intended to be a temporary device to calm down markets and was enriched by some IMF-conditionality. When Ireland had to draw on this facility in order to stabilise its banking sector, the debate continued whether Portugal and Spain would be the next candidates. It was suspected that eventually the union would lack the political power to stem such a burden which was an enlarged security net for banks and their investors. By overruling the Treaty's no-bail-out clause twice the Council had set the substance of the Treaty at stake. Going on with that kind of solidarity would end up in a European transfer union between 'weak' and 'strong' members.

Meanwhile, it has become clear why the public-debt problems in peripheral euro-area countries are so intractable and why those problems are being interpreted as a euro crisis. First, monetisation of the public debt is excluded in the European Monetary Union (Art. 123, Treaty on the Functioning of the European Union). So, in a phase of financial turmoil a highly indebted government may have troubles to re-finance its debt by issuing new bonds. As the German Council of Economic Experts has pointed out in its 2010 Report, EMU member states find themselves in a situation as if they had issued their debt in foreign currency. It is this original sin that creates peculiar solvency problems (the notion 'original sin' for external debt was coined by Eichengreen et al., 2005). Second, the peripheral member states of the EMU are highly indebted to foreign banks. The accumulation of foreign debt is largely the reflex of continued deficits in a country's current account. In the process of economic development and catching-up the peripheral countries of the EMU have financed their import-surplus by foreign liabilities. So, foreign banks which have invested their claims hold also large amounts of government bonds. According to the Bank for International Settlements, Greece, Ireland, Portugal and Spain together owe 1.9 bn US dollar to foreign banks, about a quarter of which to German banks and a sixth to French banks. Here we find the key for contagion of a public insolvency that would spread to European banks and so to the core of the EMU.

Against this background, the European Council decided to replace the temporary rescue package that will end in 2013 by a permanent mechanism. The design of this "European Stabilisation Mechanism" (ESM) was concluded end of March 2011. At the same time, a complementary 'Pact for the Euro' was concluded to tackle macroeconomic disequilibria in the euro-area. This paper analyses the objectives of the intended ESM and the institutional change that is required to establish an extended credit mechanism in the EU. It is argued that establishment of an ESM is not sufficient to resolve the fiscal and monetary imbalances that have evolved in the EMU as a consequence of the financial crisis. To the contrary, in case of an over-indebted country, like Greece, a rescheduling of public debt seems to be required in the first place. In particular, contagion effects within the EMU would be better contained. The argument is developed by analysing the recent debate to these issues. As a framework I use the macroeconomic relationship between monetary flows and stocks. First, the analytical framework is presented. Second, the institutional setting of the ESM and the rules of the complementary euro pact are described. Against this background, the macroeconomic implications of the new institutions are analysed and some conclusions are drawn.

The analytical framework

Regarding monetary flows, an external disequilibrium is expressed by the fact that real absorption (a) and real income (y) are not in balance. For a country performing a deficit in its current account, like Greece, the condition is

$$a > y;$$

that is to say, the sum of real investment and real consumption in Greece exceeds real income (the value of production). The monetary implication is that the excess of absorption is externally financed (by capital imports). In the long run, this market constellation leads to the accumulation of foreign debt. If redemption of foreign debt is required in order to regain credibility the external imbalance has to be closed. Moreover, the country in question has to perform an external surplus. For that purpose, real adjustments are required, either real productivity growth and / or a reduction of real wages. So, a deficit-country like Greece would have to steer an austerity course of economic policy for long in order to eventually reduce its external deficit. But there is another condition which has to be fulfilled. Within the EMU, a deficit-country can only be successful in reducing its deficit if its partner countries accept that their surplus is diminished accordingly.

Regarding monetary stocks, the catch-up to higher income levels requires public as well as private capital investments. So, one would expect that a deficit-country like

Greece has a high and growing public foreign debt in relation to national income, corresponding to its external deficit. When the viability of this accumulated debt is put into question, the government of an EMU member has no escape, neither into monetisation nor into inflation. But it may act as a sovereign debtor. The economic rationale for such a debtor is to service its debt so long as the net value of payments is positive (Niehans, 1986). That is to say, the net amount of borrowing should exceed the amount of interest payments. Writing δ for the growth rate of debt, $\Delta D / D$, the condition in any given period t is

$$c(t) = (\delta - i)\, D(t);$$

for c(t): cash flow in period t.

Actually, this condition is evidently violated for peripheral EMU members. They have no access to the capital market, so that net borrowing which they need to finance the process of catching-up is no longer possible. It should be mentioned that a positive rate of net borrowing does not increase the ‘debt burden’ as long as it is in line with income growth (see Domar, 1944).

Institutions of the Stability Mechanism

End of November 2010, the European Council agreed on essentials of a permanent crisis mechanism to be enacted in 2013. That mechanism’s design was then discussed in detail and concluded on March 24, 2011. The main questions to be answered concerned its volume, the shares of liability, the conditionality and the task of conducting debt management.

Volume: The Council agreed that the volume of the stability mechanism should be orientated at the EFSF. However, Brussels had demanded an extension of the stabilisation facility. The Commission pointed at the problem that the member states’ share (440bn€) was not fully available for credits due to commitments to receive the top rating for EFSF bonds. Only six members of the euro area would receive top ratings as borrowers: Germany, France, Netherlands, Finland, Austria and Luxembourg. To provide for full scale funding, the fund’s liabilities would have to be increased or – as proposed by the German Minister of the Economy – second scale tranches would have to be lent against higher interest rates. The Council decided to increase the nominal volume of the fund to 700 bn € in order to keep the top rating for the full budget of 500 bn €. In addition, part of the fund (80 bn €) shall be covered by cash deposits which have to be paid in several tranches.

Shares of liability: Capital shares of the ESM are defined according to the capital structure of the ECB with minor amendments to the benefit of East European members. Contributions to the fund are counted as assets so that credits taken on behalf of the fund do not increase a country's debt ratio nor its deficit ratio. This allows countries like Germany to fulfil its legal obligation not to increase government debt ('Schuldenbremse'). However, the fund's cash reserves cause opportunity costs with the lenders, either in the form of interest payments or foregone tax reductions. The EU Council concluded that cash deposits shall be paid until 2017, in five equal tranches of 16 bn €. Nonetheless, the deposits shall not fall below 15% of the actual ESM credit volume in order to not endanger top ratings for these credits. ESM spreads have also been defined: Interest that has to be paid on ESM credits will cost 200 basis points above market rates, after three years of maturity the spread will increase by additional 100 basis points. Even so, ESM credits will be cheaper than credits handed out by the EFSF. The ESM shall be constituted as an international financial institution like the IMF. One major implication is that an orderly insolvency procedure for governments that would have obliged private investors to participate in the cost of a rescue package was excluded. Like with the IMF, a debt restructuring programme will only be an 'ultima ratio' which is tailored case by case. Economists have pointed out that the lack of an orderly insolvency procedure for member states of the euro area changes the character of the fund. It is argued that a European rescue mechanism would degenerate to a permanent credit facility if it was not complemented by an order of insolvency and instead provided salvation of their investment risk to private investors (see, for instance, the Report of the Economic Experts advising the German Minister of the Economy, 2010).

<u>Conditionality:</u> The terms of conditionality have been tailored according to IMF rules. Although the IMF in its recent statements has taken leave of the Washington Consensus, conditionality still means that austerity programmes are imposed on the governments concerned and structural reforms are demanded. Evidently, neither the EU nor the IMF and the ECB are concerned about the contradictions of those measures and the macroeconomic implications that may arise.

<u>Debt management on behalf of EMU members:</u> As an emergency measure to assist illiquid banks during the financial crisis the ECB had started to purchase government bonds in the secondary market. Since May 2010 it has taken 76.5bn€ of government bonds in its portfolio (until 18.1.2011), mainly Greek bonds but also Portuguese, Irish and Spanish bonds. These purchases have come in addition to the Emergency Lending Assistance (ELA) provided by national central banks in peripheral EMU countries, particularly in Ireland. Since they are not justified except for acting as a lender of last resort and set the ECB's independence into question, the ECB urgently wants to get rid of those assets. On several occasions, Jean-Claude Trichet, president of the ECB has demanded to extend the stabilisation facility 'in quantity and quality'. However, there is no unanimity in the ECB's Governing Council on this question. In its monthly report of February 2011, the German Bundesbank takes a critical view on plans to extend the tasks of the ESM fund. The fund should not be entitled to buy bonds of illiquid or insolvent governments. Also, credit to those governments to enable them to buy back their bonds in the market would be a first step into a transfer union and exert false incentives. The Bundesbank's view was particularly shared by the German government. Nonetheless, the ESM eventually was entitled to buy government bonds on the primary market and so to take over debt management tasks on behalf of EMU member states.

In addition to the stability mechanism ESM, the European Council provided a scheme to satisfy the increasing demand for more coordination of national economic policies within the EMU. Besides measures to sharpen the blunt weapon of the Stability-and-Growth Pact, new rules were discussed to avoid the development of large macroeconomic imbalances within the monetary union which might have detrimental effects on the ‘competitiveness’ of member states. This debate has its parallel on the global scale, where a currency system ‘of no commitments’ (and hidden protectionism) prevails that allows for the emergence of big external imbalances, in particular between China and the USA. So, the G20 summit of November 2010 discussed a US proposal to establish indicative guidelines for the restriction of current account imbalances. This US suggestion has met widespread opposition. The plan was aimed particularly at China and Germany which performed external surpluses of 4.7% and 6.1% of GDP, respectively, in 2010. The debate on indicators was continued at the G20 summit in Paris, in February 2011. Germany and France proposed five indicators: the current account balance; real exchange rates; currency reserves; public deficits and public debt; private savings ratio. China preferred the trade balance as an indicator. The summit has concluded indicators for public and private debt, private savings, net investments and the trade balance. Exchange rates are mentioned as a sub-indicator, currency reserves are excluded. No target values and no sanctions have been adopted.

As to the euro area, large national surpluses (Germany, Netherlands et al.) and deficits (France, Spain) are balancing so that the euro area’s surplus vis-à-vis the rest of the world amounts to $21bn only in 2010, 0.2% of GDP. Nonetheless, the debate here concentrated on the heterogeneous economic structure of the monetary union, following the idea that a monetary union should be a homogeneous economic space. This idea which contradicts basic insights of the efficient allocation of resources in a market economy and the liberal principle of international specialisation, has been the core of critique, questioning the viability of the EMU from its beginning. In the political arena, the academic debate was watered down to the concept of competitiveness. In order to avoid macroeconomic imbalances, all member states of the EMU should improve their ‘competitiveness’. In February 2011, the German chancellor Angela Merkel proposed a ‘pact for competitiveness’ as a response to the well known French plan to establish a European Economic Government. The pact takes up the idea of combating macroeconomic imbalances that has been discussed since the G20 summit in November 2010. Indicators for measurement of imbalances within the euro area are proposed, in particular ‘real unit labour costs’ as a measure for real exchange rates within the monetary union. (Evidently, this indicator does not make sense except for measuring national unit labour cost and deflating this index with a European price index. But what kind of price index? Take the HICP, which is familiar and also used by the ECB in calculating competitiveness, and you will end up with the Balassa-Samuelson problem as tests for Ireland or Greece may show.)

The controversial part of the announced ‘pact’ was that member states disclosing macroeconomic imbalances should be obliged to undertake specific ‘economic policy reforms’ which all over Europe were seen as a German dictation: To introduce a debt limit on public debt, to harmonise income tax rates and retirement age and to abolish wage indexation. To coordinate the debate and prepare a consensus, Jose Manuel Barroso and Herman Van Rompuy presented a paper that was discussed at the EU summit on March 11. In this paper, the Merkel-proposals have been watered down to the proposition that the European Council holds annual meetings to discuss the economic policy strategies of member states. No sanctions shall be charged if there are macroeconomic imbalances or structural problems. The coordination of economic reforms should remain part of the normal legal procedure in the EU. So, the Commission would remain master of the procedure in issues of economic policy coordination, defending particularly its right of taking initiatives. The paper prepared the ground for the Euro-Council decision of a ‘Pact for the Euro’. In particular, member states commit themselves to adopt economic policy reforms but retain political responsibility. Reforms shall be discussed in an annual meeting. No sanctions have been concluded. This agreement was later also accepted by some member states that do not belong to the euro area (‘euro-plus-pact’).

The case for sovereign-debt release

The institutions of the stability mechanism that were concluded by the European Council exclusively rely on means and ways to correct income flows. To resolve their public debt problems the peripheral EMU countries have to achieve primary surpluses in their budget balances and, in addition, external surpluses in their current accounts. Since they have to bridge a presumably long phase of insolvency (ie when they have no access to capital markets at reasonable cost) they shall receive financial assistance by the ESM. The measures to achieve the required reduction of real absorption in relation to real income correspond to traditional IMF rules. In the monetary regime of the EMU which is a regime of low inflation this is a flawed concept. First, income analysis indicates that growth enhancing reforms require additional public borrowing for some time. Second, a deflationary process of reducing real absorption and achieving a surplus in a country’s current account can only be successful if the partner countries accept an increase of their respective deficits. But the ‘Pact for the Euro’ does not allow for this kind of compensation since it demands from all member states to improve their ‘competitiveness’. So, an adjustment of real exchange rates will not be achieved by the austerity programmes and the competitiveness-race turns out to safeguard the competitive positions of surplus-countries like Germany. Instead, a general deflation may be triggered off within the EMU.

Member states should recognise, therefore, that it is not in their interest to resolve the debt problems of peripheral EMU countries exclusively by austerity. To provide 'temporary' financial assistance does not help either. To the contrary, it may worsen the debt problem. A necessary condition for overcoming the consequences of the financial crisis is the revaluation of monetary stocks. This, at least, is what stock analysis tells us: to correct for the price distortions in financial markets, to revalue overvalued bank assets, to clear bank balance-sheets and if necessary to recapitalise banks. Nothing of this is resolved by ESM credits. Instead, these 'temporary' credits nurture the borrowers' dependence on official credit facilities; they dampen incentives for banks to clear their balance-sheets; and the very existence of these facilities exerts disincentives for investors to be concerned about credit risk. So, the ESM will contribute to a long endurance of the debt crisis.

At this point of the analysis we recognise the economic rationale of a sovereign-debt release. It is to set prices and values in financial markets right and to rely on economic incentives in a world of uncertainty. A debt release for an insolvent country is a market solution, not a policy solution. It is led by the insight that in a monetary economy a debtor and a lender are two men in a boat. Parting with money, the lender has to take risk. There are several well established techniques of sovereign-debt release or, in technical terms, of restructuring (see for instance The Economist April 23rd 2011, with reference to Greece). Principally, we may distinguish

<u>Write-downs on the value of the debt:</u> Bonds of Greece, Ireland and Portugal (in total 650bn €) are traded at less than 80% of par value (on average) although the ECB has started a programme of purchasing these bonds (holding about 76bn €) with the consequence that prices were stabilised. Writing down these bonds would immediately reduce the governments' debt burdens – and interest payments – and at the same time would re-value bonds held by banks in their banking books and clear banks' balance-sheets. This might require a recapitalisation of banks, in particular Greek banks.

<u>Maturity extension ('reprofiling'):</u> With the interest burden unchanged, a government's need to issue new bonds may be postponed by extending the maturity of existing bonds. Evidently, this helps if a government has a liquidity problem but is solvent. In this case banks need not write down bonds they hold in their banking books. 'Reprofiling is thought unlikely to trigger payments on credit-default swaps' (The Economist, p. 75). It was proposed by the Deutsche Bundesbank as a complement to the ESM (see Weber et al., 2011) and seems to have a backing in the European Council in the case of Greece.

<u>Bond buy-backs:</u> A government in financial trouble could be assisted in buying its bonds back at current, depressed prices. Such a scheme was successfully conducted during the South-

American debt crisis ('Brady bonds'). In the current European debt crisis, Daniel Gros and Thomas Mayer (2011) made a similar proposal suggesting ESFS swaps. The Economist critically comments such a scheme, pointing at the tendency that prices are driven back up again (op.cit.).

Still, a sovereign-debt release is seen very critically in the political debate and even more so by the ECB. The fear is that ratings of government bonds all over Europe would suffer with the consequence of an increase of interest rates in the European bond market. If this was the case, it would be a market solution: The increase of interest rates indicates a perception of higher risk. The question arises why politics and the ECB stem against this solution and if they can successfully avoid it. This is a question of the political economy. Apart from the ECB which cannot be stopped to serve vested interests of the banking industry in the short run, politicians are coming under pressure since they have to win votes. Recent elections all over Europe show that voters are not willing to back policy solutions that lack an economic rationale. That might eventually bring politicians to the insight to pursue 'reasonable' policy solutions against vested interests and a powerful European bureaucracy.

Conclusion

What seems necessary to restore viable relations within the EMU is a depreciation of the nominal value of the sovereign debt of peripheral countries in order to reduce the amount of interest payments in relation to net borrowing. Moral hazard problems that might arise concern the future and have to be taken seriously. However, they seem to be more tractable than moral hazard problems induced by bail-out solutions. How much remains of those problems in the end, depends largely on the design of an orderly-insolvency procedure.

The analysis of the stock-flow problem in the EMU should have demonstrated that a pure flow-solution of the public-debt problem which has been pursued until now goes with high social cost and also implies the danger of deflation. So, a re-valuation of monetary stocks (and clearance of balance-sheets of investors, particularly banks) seems to be necessary in the EMU to resolve the debt crisis. In this respect, a monetary union is not different from other currency regimes. However, in the light of recent events, the costs and benefits of a monetary union may be weighed differently.

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