από Θ Κουτσογιώργη

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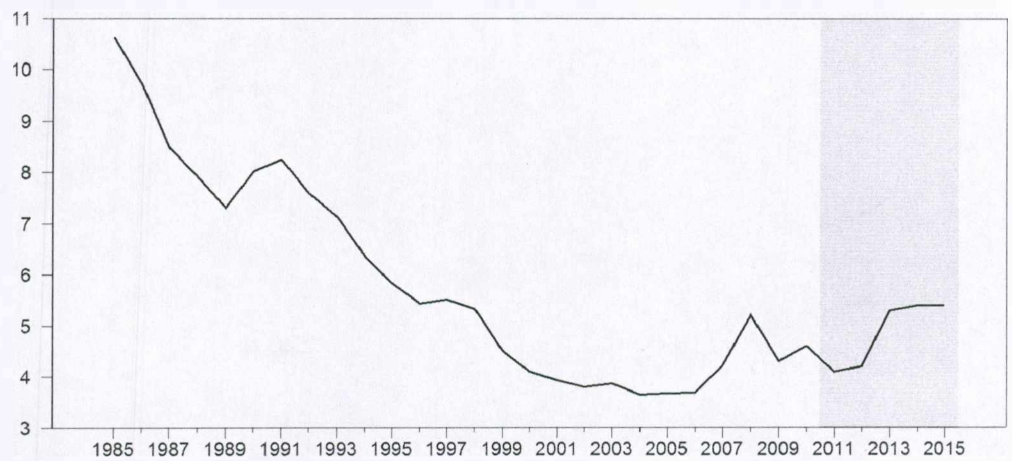
long maturity of seven and half years, so Ireland will not be under huge pressure over the next few years to replace this funding with private borrowing. Thus, official projections are based on the idea that the average interest rate that the Irish government will pay on its debt will stabilise at about 5.4 percent in 2014 (see Figure 14) which provides room for a small primary surplus to start reducing the debt ratio.

Figure 14: Average Interest Rate on Irish Government Debt



There are also some compelling arguments against the official scenario. The assumed return to steady 3 percent growth may be too optimistic. Ireland cannot rely on a return of many of its previous sources of growth such as productivity catch up, demographic patterns and growth in participation.

Fiscal adjustment and debt overhang problems will continue to depress domestic demand. And while the Irish government regularly points to the role improving competitiveness should play in boosting exports in the coming years, the plan appears premised on a smooth recession-free ride for the world economy in the coming decade. It also assumes that the government will not be providing further funds to recapitalise the Irish banking sector, which owes vast quantities to emergency lending to the ECB and Irish Central Bank. Taken together, the official analysis paints a fairly rosy scenario which may not come to pass.

Another factor worth noting is that Ireland's debt burden looks even higher when measured relative to GNP as opposed to GDP. For most countries, there is very little distinction between these two measures. However, a large (indeed, increasingly large) fraction of Irish output is due to profits that are repatriated by multinationals. The relatively low corporate tax rate of 12.5 percent that is charged on these profits has been a repeated source of controversy but it is unlikely that the Irish government is going to introduce large changes to this rate as it is seen as central to industrial policy. For this reason, most of the tax burden falls on the domestic incomes measured by GNP and as the blue line in Figure 12 illustrates, this measure of the debt-burden is set to top 150%.

As of now, financial markets appear to be placing more emphasis on the negative factors than on the positive factors stressed by the EU and the IMF. Yields on Irish government debt are above 10 percent and this pricing appears to be based upon the assumption that there will be a debt restructuring. Against this background, the official plan's assumption that private sovereign borrowing will recommence in late 2012 seems optimistic. There may be some secondary market activity in Irish debt at the current high yields but it's questionable whether Ireland can sell the large amounts of debt that would be required to finance itself once the EU and IMF funds run out.

An ESM Solvency Test?

Based on the European Commission's projections, Ireland is likely to run out of money in early to mid-2013 if it cannot access funds in the private sovereign bond market. At present, my guess is that Ireland will not be able to sufficiently return to the sovereign bond market to avoid having to request funds from the new European Stability Mechanism.

According to the ESM "term sheet" released in March, a request for funds from the ESM will require a "sustainability analysis" to assess whether "a macro-economic adjustment programme can realistically restore the public debt to a sustainable path."[8] If the debt burden is deemed unsustainable, then "the beneficiary Member State will be required to engage in active negotiations in good faith with its

8 See www.gouvernement.lu/salle_presse/actualite/2011/03-mars/21-mes/esm.pdf

creditors to secure their direct involvement in restoring debt sustainability."

It is not clear how such a sustainability analysis will work but if the Irish government manages to stick to its current adjustment programme and the macroeconomic assumptions underlying this programme come to pass, it seems likely that an ESM analysis will produce similar projections to those currently published by the EU and IMF showing a stabilisation and reduction in the debt-GDP ratio. Most likely, under such a scenario, the debt will be deemed sustainable. If, however, Ireland falls short of the targets set in the current adjustment programme and the debt outlook looks worse in 2013, then this will raise the question of whether private sector debt should be restructured.

A Uruguay style "light dusting" restructuring (to borrow the phrase used by Buchheit and Gulati, 2011)[9] in which maturities are extended while coupon payments are maintained at existing levels, may prove attractive for the EU and IMF because a second deal for Ireland would see the balance of risk on Irish sovereign debt shifting over from private bondholders to the official sector. Moreover, with both the IMF and soon the ESM claiming a creditor status that is senior over private bondholders, such a deal could be a tipping point that rules out private purchases of Irish government bonds for a number of years. A light dusting approach would lock in a large volume of privately supplied funds that could share the burden that could be associated with any later more severe restructuring of Irish sovereign debt.

Which route is chosen, and how any potential restructuring is organised, are likely to depend on events elsewhere. Greece appears to be closer to the point of sovereign debt default than Ireland and the consequences of any attempts to restructure Greek debt would have a significant impact on the attitude of the European authorities to applying a similar approach to Ireland.

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9 Buchheit, Lee and G. Mitu Gulai (2011). "Greek Debt – The Engame Scenarios", *Life in the Eurozone With or Without Sovereign Default?* Eds. Franklin Allen, Elena Carletti and Giancarlo Corsetti. USA, FIC Press 2011, pp.83-95. e-book

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Quo vadis, Euroland? European Monetary Union Between Crisis and Reform

Martin Hellwig

1. European Monetary Union Before 2008

Developments of the past year have led many to say: We told you so. European Monetary Union was bound to erode the stability culture that the Bundesbank had nourished so that other countries were bound to follow. The temptation to finance budget deficits through the printing press would be overwhelming. And this prediction has now been confirmed. All the safeguards of the Maastricht Treaty and the Stability and Growth Pact have come to naught.

This reaction comes in particular from German economists, many of whom accompanied the formation of European Monetary Union with dire predictions. They forget that the Maastricht Treaty and the protection that European Monetary Union provided to the Bundesbank prevented Mr. Lafontaine, the new Federal Minister of Finance in 1998, from changing the Bundesbank Act so as to make the institution subservient to the Federal Government. They also forget that Mr. Schröder as Federal Chancellor was most prominent in preventing the application of the Stability and Growth Pact in the early 2000's. In other words, erosion of the stability culture of the Bundesbank is also a matter of generation change within Germany. There are reasons to believe that European Monetary Union has slowed this erosion rather than accelerated it.

I have previously commented on these developments in a contribution to the Festschrift for the Centenary of the Swiss National Bank, which was written in 2006 and published in 2007.[1] At the time, I stressed the following points:

- Through the formation of the European Monetary Union, monetary policy has been depoliticized. Whereas the Bundesbank was very much a part of German political debate, the ECB as a supranational institution is removed from national political debate. Moreover, national politicians who rail against the ECB's policies find that there are usually other politicians, from other countries who have different views about these policies – and who insist that the ECB is as much, or as little, beholden to them as to the railing plaintiff.
- Depoliticization does not imply an end to frictions and disputes. Disputes about the appropriate intermediate targets of monetary policy or about the tradeoff between a reliance on rules and discretion arise naturally, and the central banking community is the more likely to cultivate these conflicts, the less it feels threatened by politicians and governments. In the case of European Monetary Union there are ample grounds for such "professional" disputes because the pursuit of price stability in an area with multiple non-integrated market systems presents a difficult new challenge. Moreover, it might take time, for the institution and the surrounding media, to get used to the much decreased importance of the exchange rate.
- Threats to the ECB's independence might be expected to come from the European Commission. The European Commission has a history of ambition to enlarge its own turf. This ambition has mostly worked against Member State prerogatives, but there was every reason to expect it to work against the ECB as well. In fact, in the discussion about

1 "Switzerland and Euroland: European Monetary Union, Monetary Stability and Financial Stability", in: The Swiss National Bank 1907 – 2007, Zürich 2007.

the Constitution for the European Union, the President of the ECB had already found it necessary to protest against a suggestion, which he understood to have come from the Commission, that would have "simplified" the procedure changing some of the strategically important articles of the Statute of the European System of Central Banks and the European Central Bank.

- Lack of credibility of the "Stability and Growth Pact" was identified as a problem. It therefore seemed likely that, at some point over the medium run, we would come across a problem like the one that Greece has posed over the last year. For this eventuality, in 2006/7, I predicted that the European Union would move forward as it had in past crises, with a mixture of muddling through and changes in governance. I warned that, in such a context, the ECB's independence might be at stake. If a Treaty revision introducing a mechanism to deal with the fiscal crisis of a Member State government were to stipulate that, in such a crisis, the ECB should contribute to reducing damage and frictions and if this stipulation was part of a larger package, then the requirement that changes to the Treaty must be ratified by parliaments in all Member States would not be worth much as a safeguard for the ECB's independence.
- Finally, I argued that there is an unnatural tension in a system with a supranational authority for monetary policy and national authority in banking supervision. While appreciating that bail-outs of insolvent banks belonged in the domain of national finance ministers, I suggested that mechanisms of co-ordination and assignments of tasks for the national authorities and the central bank as a lender of the last resort were not sufficiently well specified. The information that transpired about the various memoranda of understanding on the matter did not inspire much confidence.

2. Why Is the Current Crisis so Difficult to Handle?

With hindsight, it is clear that my analysis in 2006/7 was too sanguine. Whereas I expected the coming fiscal crisis of a Member State to be dealt with pragmatically, without too much ado, the Greek sovereign debt crisis has now been with us for over a year and the European Union is still far from finding a way out and from establishing workable governance mechanisms for the future. Moreover, we are not just dealing with the Greek sovereign debt crisis, but with crises in other countries as well.

The main reason why it has been so difficult to come to terms with these problems is that we are not just dealing with one crisis, but with three crises at the same time. We have, first, the kind of fiscal crisis that we see in countries like Greece and Portugal. We have, next, the kind of banking crisis that we see in countries like Ireland or Spain, where local banks have gone on lending sprees and nourished real-estate bubbles and, when the bubbles burst, their solvency was impaired. We have, finally, the kind of latent banking crisis that we see in countries like Germany or France where banks with very fragile balance sheets have large exposures to sovereign debt from Southern Europe and/or to bank debt from Ireland and Spain. These three crises are entangled with each other, and it is difficult to disentangle them.

The difficulties came into evidence after the Deauville meeting of Merkel and Sarkozy when they announced that, in the future, under the successor to the EFSF, any support of sovereign debtors would require a bail-in of creditor banks. Merkel and Sarkozy thought that they were just talking about the future, a regime that was to be imposed after 2013. But they forgot that, as of now, there are outstanding bonds that will mature in 2020. Would such bonds benefit from a grandfathering clause? Or would the bondholders be subjected to the bail-in requirement after 2013? Just raising the question creates unrest for today's financial markets – and for the German and French banks that may be holding such bonds. And what about debt that will be maturing in 2012? This debt will have to be refinanced, perhaps by issuing new debt with a maturity extending beyond 2013. Conditions under which this debt can be issued in 2012 will depend on prospects for how this debt will be treated after 2013. These conditions in turn affect how today's holders of debt maturing in 2012 assess the prospects of actually receiving their dues. These considerations show that it is difficult to even talk about proper governance post-2013 while we must be afraid that the effects of such talk will disturb today's markets and deepen the triple crisis that we have.

Following the markets' reactions to the Deauville announcement, EU finance ministers tried to quiet the markets by saying that bail-ins would only be required when a debtor were to have a solvency problem. For support with liquidity problems, no bail-in would be required. To me, this is another example where concern about the current mess precludes a sensible discussion of future governance. From a debtor's perspective, the problem is always just a liquidity problem. And the private creditor will agree if that helps him avoid a bail-in. If you think about the substance of the matter, you will notice that, for sovereign debt, the concept of insolvency as an objective inability to pay is not an operational concept. To assess a sovereign debtor's ability to pay, one would have to deal with questions like: What is the debtor country government's ability to get the country's elites to pay taxes? What is the debtor country government's ability to get a political consensus for selling assets? What is the debtor country government's ability to restrict public-sector salaries? These questions have played a key role in sovereign debt crises, in Weimar Germany as well as the Latin American countries in the eighties, in Greece and, to some extent, even in the United States today. Because these questions go to the core of what makes a national polity and society, I see no scope for providing "objective" standards for dealing with them. By relying on the non-operational distinction between insolvency and illiquidity, the finance ministers lay the foundations for bad governance in the future.

If we were able to clean up the current crises right away, we might be able to have a clean slate for discussion of governance after 2013. Unfortunately, this is not very likely. To some extent, this is a matter of technical and legal problems. More importantly, there is no political will to clean things up right away. On this point, Germany bears much responsibility. From the very beginning of its intervention in the financial crisis, in October 2008, the German government has been bent on preventing transparency about the costs of intervention by shifting risks into the future. In October 2008 and the following months, support was mainly provided in the form of guarantees. As we all know, guarantees do not cost anything, and they do not have to be put on the budget. The "bad bank" law in 2009 allowed banks to place dubious assets with the government. The government takes current write-offs (or not) on these assets, and a reckoning with the banks is deferred for twenty years. The support package for Greece and the EFSF have the great advantage that you do not have to tell the taxpayers that you are bailing out banks again. The advantage is all the greater if you can say that you are just dealing with a liquidity problem and no taxpayer money will be lost. I am afraid that, as long as there is no change in attitude concerning the costs and benefits of transparency, we will not be able to clean up the system, and discussions about governance after 2013 will be contaminated by all three of the crises that we have right now.

In this context, it is not helpful that so much of the political discussion last year has been formulated in terms of solidarity and in terms of a currency crisis. There has been a lot of discussion of the sort that if it was not for Greece or Spain, German exports would not be doing as well as they are. Therefore, Germany should feel an obligation to support the peripheral countries with their debt problems. The story can also be told in another way: If it had not been for European Monetary Union, the interest rate premia for the peripheral countries' sovereign debts would probably have remained where they were prior to 1995, which, except for Greece, is twice as much as what they have become *after* the crisis – and a large multiple of what they were before 2007! And Germany would have had a higher real investment and higher real growth in the first half of the decade. This part of the story should presumably be part of the solidarity equation as well.[2]

More importantly, talking about these matters in terms of solidarity creates significant political risk. Solidarity is a big word which means different things to different people. For a government to use taxpayer money in the name of solidarity, there must be some acceptance of this solidarity among the electorate. In this respect, there

2 H.-W. Sinn, Rescuing Europe, CESifo Forum 11, Special Issue, August 2010, W. Franz, C. Fuest, M. Hellwig and H.-W. Sinn, A Euro Rescue Plan, CESifo Forum 11, No. 2, 2010, pp. 101–104.

are significant differences across countries, even for solidarity within the country itself. Outside of certain political and intellectual elites, there is as yet little acceptance of any general notion of cross-border solidarity within the European Union. Public political discussion in the European Union mostly takes place along national lines. Within the different national discourse communities, notions of solidarity towards other nations tend to be seen with suspicion. The European Union is seen as a mechanism that siphons off money from national uses. The turbulence of last year's discussions has very much reinforced these suspicions. We may deplore the populism that we see in these debates, but we should not underestimate the risk of an uncontrollable political backlash – in all affected member states. In this respect, the open disrespect for existing law that has been shown by many participants has been very harmful. So has been the lack of transparency about who is being supported, public employees in Greece taking early retirement or German and French banks avoiding significant write-offs.

The discussion has also not been helped by euro-skeptical journalists and populist politicians interpreting the crisis as a currency crisis. The crisis is *not* a crisis of the euro and its internal or external stability. The internal purchasing power of the euro has not been affected. The external purchasing power of the euro has declined somewhat in the spring of 2010, but the devaluation *vis à vis* the dollar was hardly more than a correction of an excessive revaluation in the years 2002 – 2009, excessive that is, relative to differences in inflation rates. Journalists and politicians like to tell stories about such exchange rate movements, but there is no story to be told. Movements like the ones we have seen have been a recurrent phenomenon since the reintroduction of flexible exchange rates in the seventies, and for most of them we do not have any explanations. (I also would not wish to refer to the subsequent revaluation of the euro vis à vis the dollar as an indication that the crisis has been overcome.)

As for the governance of the euro, I appreciate that, over the past year, there has been a lot of controversy about the behavior of the ECB. However, I do not see this development as running counter to the depoliticization and professionalization of the debate about monetary policy that I had observed in previous years. The discussions that we have had about ECB policy during the last year and a half have mostly not been about issues of independence of the central bank or about the responsibilities of the ECB for the overall economy. These discussions have been narrowly focused on how the ECB should deal with the crisis. Leaving aside the legal question of whether the ECB's decisions and policies are compatible with the Treaty, I believe that most of those discussions can be interpreted as instances of reasonable professional dissent in central banking. Thus, I do not see the ECB as having been captured by President Sarkozy or any other head of government or head of state.

There is a lot of criticism against the ECB buying up all sorts of things, including strange assets, toxic assets, etc. I have no idea what the quality of these instruments are but I have been thinking that, if the losses are there anyway, they have to be borne by someone and, if the banks that invested in these instruments are unable to bear them, then using seigniorage to cover these losses may not be the worst idea. I do, however, fear that if political systems or financial systems get used to the ECB solving their problems, then using seigniorage to underwrite losses on poor investments will end up being a very bad idea indeed. This is precisely why I believe that we need to think about what an appropriate and credible governance system for the period after 2013 would be.

3. Underlying Problems That Must Be Addressed

The preceding remarks indicate why the current crisis is so serious and why it is so difficult to get out of it. I now turn to the issues that we need to think about when we ask what would be a good system of governance for the future. In so doing, I will make believe that the problem of transition out of the current crisis can be ignored and proceed as if we could start with a clean slate.

If we think about what actually went wrong over the last decade, we must be concerned about the implications of the lack of an exchange rate mechanism for capital flows and for governance in the euro area. In providing a fairly sanguine assessment of European Monetary

Union in 2006, I very much underestimated this problem.
We have a common currency, but *not* a common price system. Markets are not integrated to such an extent that regional and national price movements are as highly correlated as they would be in a single sovereign region or country. Year by year, the variance of inflation rates across the different member states of Euroland is much higher than the variance of inflation rates across American states, Swiss cantons, or German Länder. If exchange rates were flexible, these differences in inflation rates would by and large be reflected in exchange rate movements. Anticipation of exchange rate movements would force nominal interest rates to be different in different countries.

In a currency union, however, the exchange rate is fixed, and there is no reason why borrowers in different countries whose credit risks are similar should be charged different nominal interest rates. When nominal interest rates are the same, however, differences in inflation rates induce differences in real interest rates. In countries with higher inflation rates, real interest rates are lower, and, *ceteris paribus*, investment demand will be higher. Higher investment in turn boosts aggregate demand, which contributes to rising prices. Some of the capital flows that we have seen in the years before the crisis reflected these differences – in inflation rates, real interest rates and investment demand – and reinforced them. Thus funds flowed from countries like Germany, where inflation was much below the average and therefore real rates were higher, to banks – and ultimately real-estate investors in countries like Ireland and Spain where inflation rates were higher and real interest rates accordingly low. For public debtors in the peripheral countries, there also was the temptation to borrow more as entry into the European Monetary Union had eliminated the high risk premia that they had had to pay in the past.[3]

I am not concerned about these capital flows *per se*. As a consequence of monetary union, some such capital flows were to be expected – and were fully intended. Previous interest rate differentials had been very high and had contributed to preventing capital from flowing to destinations where it would be most productive. After all, these interest rate differentials contained not just the premia for expected

3 On this argument, see again Sinn (fn. 2) and Franz et al. (fn. 2).

differences in inflation rates or expected exchange rate movements, but also the premia for the associated exchange rate risks. Eliminating these impediments to the flow of capital would contribute to raising welfare in countries receiving these flows and putting them to productive use as well as providing returns for investors in countries with surplus savings.

However, governance mechanisms for these capital flows were insufficient. Capital flows to banks in Ireland and Spain took too little account of the dangers inherent in the Wicksellian dynamics of real interest rates, investment and housing price appreciation generating a bubble. In Greece and Portugal, there was too little concern about fiscal sustainability. In both contexts, there was a lack of discipline, on the side of lenders as well as borrowers.

This lack of discipline was to some extent due to the lack of an exchange mechanism. For a country that has its own currency, the exchange rate typically provides a disciplining mechanism. This mechanism may work because it goes against the country's pride to see the exchange rate devalued, and therefore policies that destroy the international competitiveness of important industries may come to be questioned when the loss of competitiveness affects the exchange rate. Or it may work because lenders distrust the country government's ability to finance its activities without using the printing press and therefore refuse to lend in the country's currency, a constellation which Eichengreen and Hausmann have called *original sin*.[4]

Many argue that, if only Greece or Portugal had been able to borrow in their own currency, they could now devalue their currencies and they would be fine again. Arguments get the matter backwards. If these countries still had had their own currencies, they would not have been able to borrow in their own currencies in the first place, at least not to the same extent and at the conditions that they actually got. Given the constraints on domestic-currency borrowing, they might have borrowed in foreign currencies, but, as they did so, they would have had to consider the risks inherent in such borrowing.

4 B. Eichengreen and R. Hausmann, Exchange Rates and Financial Fragility, in: Federal Reserve Bank of Kansas City, New Challenges for Monetary Policy, Kansas City 1999, 329 – 368.

With significant foreign-currency-denominated loans outstanding, they would have to consider that a devaluation of the currency would not only restore the international competitiveness of some industries but also inflate the value of their foreign-currency-denominated debt in terms of the home currency. The experiences that Latin American countries have gathered over the past three decades with different exchange rate policies provide ample warnings. None of them has been able to eliminate the consequences of original sin, the inability to borrow freely in one's own currency and the risks inherent in foreign-currency borrowing.

In Euroland the disciplining mechanisms that are based on exchange rate movements and exchange rate risks are missing. On the one hand, as mentioned, this reduces frictions and enhances efficiency in cross-border capital flows. On the other hand, it increases the temptation for sovereign borrowers and their lenders to neglect fiscal sustainability.

Fiscal sustainability, fiscal discipline and a respect for (intertemporal) government budget constraints are important because each member state government is in principle independent and sovereign in its own fiscal policy. This independence is the only way to accommodate the very different attitudes towards fiscal policy and, more fundamentally, towards the role of the state that we have in different countries. For instance, the UK has a very strong market orientation in economic policy, the French government a very strong desire for state control over the economy. (Germany is somewhere in between, in principle very market oriented but in the details sometimes quite interventionist.) These differences induce difference in the extent to which economic fluctuations put the government at risk. It would be difficult to put the implied fiscal policies under a common set of principles.

Differences in attitudes towards the role of the state also concern the question how much society, and in particular the social and economic elites, are willing to pay for the state. In the case of Greece, as in Latin America three decades ago or Weimar Germany in the twenties, we are not just talking about an external transfer problem; we are also talking about an internal transfer problem due to the unwillingness of significant parts of society to contribute to government finance.[5] In this context, of course, we also must take account of the expensive monuments that statesmen like to build to themselves, Olympic Games and the facilities that they require, or certain kinds of industrial policy, industrial policy as a disguise for social transfers or industrial policy as a realization of economically unviable technical dreams like the Concorde.

In all these issues, political legitimacy is derived from national political discourse. EU interference is resented and cannot be taken too far. Therefore, it is all the more important for participants in national discourse to be aware of the fact that the government is subject to a budget constraint, and that the presumed benefits of certain policies and certain monuments must be compared to their costs. In this respect, the elimination of a disciplining mechanism for government borrowing is very problematic.

The Stability and Growth Pact should have provided for such a mechanism, but in the early 2000's, Germany and France prevented its application because their governments considered the Pact to be an infringement of their sovereignty. This experience carried a more general lesson, namely, arrangements for imposing fiscal discipline will not work if the parties whose job it is to enforce them are not interested in doing so. This was true of the Council with the Stability and Growth Pact. It was also true of the Commission with the No-Bail-Out Clause of the Maastricht Treaty. In last year's crisis, the Commission had nothing to gain by fulfilling its official role as a guardian of the Treaty. In contrast, it had a prospect of significantly enlarging its own turf by working towards a new regime that would provide for inter-state bail-out in the European Union. Given these experiences, I find it remarkable that negotiations about future

5 On the internal transfer problem in Latin America in the eighties, see H. Reisen and A. v. Trotsenburg, Developing Country Debt: The Budgetary and Transfer Problem, Development Center Studies, OECD 1988, on Weimar Germany, see H. James, The German Slump: Politics and Economics 1924 – 1936, Oxford University Press, Oxford, 1986, and S. Schuker, American "Reparations" to Germany, 1919 – 33: Implications for the Third-World Debt Crisis, Princeton Studies in International Finance No. 61, 1988, International Finance Section, Princeton University, Princeton, N.J. 1988.