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November 9, 2011 3:04 pm

German economists urge vast euro debt fund

By Quentin Peel in Berlin

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The German government's top independent economic advisers have called for further radical steps to restore confidence in eurozone financial markets, including the creation of a massive €2,300bn jointly guaranteed European "debt redemption fund".

In a hard-hitting report delivered on Wednesday to Angela Merkel, the German chancellor, the five senior economists warned that the present crisis measures might still prove inadequate to break the "vicious circle of an intertwined sovereign debt crisis and a banking crisis".

Their top-line recommendation is for a "debt repayment pact" between the eurozone members, designed to bring their outstanding public debt below 60 per cent of gross domestic product via a common redemption fund.

In return, the participating countries would be able to partly finance their debt through a fund backed by joint liability, the so-called "five wise persons" propose.

The fund would accumulate a portfolio of bonds worth some €2,300bn, they say, with Italy holding the largest share – of more than 40 per cent – and Germany having 25 per cent. France, Spain and Belgium would also be major participants.

Yet their plan – the most radical yet to emerge from the German economic establishment – is likely to face fierce political resistance in Berlin, because it calls in effect for Germany to be a principal guarantor of its eurozone partners' debts.

Ms Merkel immediately warned that any such debt fund would require sweeping changes in the treaties of the European Union, and also overcome serious constitutional objections in Germany itself.

The economic advisers warn that if the nervousness of financial markets persists, the €440bn European financial stability facility would prove inadequate as a firewall against contagion, leading either to the "uncontrolled collapse of monetary union or the original sin of unlimited purchase of securities by the European Central Bank".

They insist that Germany has a "particular responsibility" in overcoming the euro crisis. They say the German economy remained "remarkably robust" in 2011, but forecast that an annual growth rate of 3 per cent in 2011 would slow to 0.9 per cent in 2012.

Indeed, they warned that if the sovereign debt crisis in the eurozone were not contained, growth would slow to 0.4 per cent. If it caused global distortions and a stagnation of world trade, Germany could even slip into recession next year.

The five professors had sharp criticism for the failure of politicians to convince the German public of the benefits – and costs – of sharing a common currency, and for German commentators who longed to return to the Deutschemark.

"Whatever measures are taken to solve the euro crisis will entail great expense and considerable uncertainty," they said. But German critics of the euro too often "conflated their commiserations at the euro's unfortunate demise with congratulations on the imminent resurrection of the D-Mark".

"Germany has been a principal beneficiary of monetary union up to now," they added. "Safeguarding the stability of the euro is not only in the interests of Europe, it is also in Germany's best interests."

Their plan for a debt redemption fund would be a "very different animal" to jointly guaranteed eurobonds, they said, with an automatic debt rundown over time, by means of a fixed schedule of repayment obligations, and subject to restrictive conditions.

A debt consolidation path would be set for each country, under which it would be obliged to redeem its transferred debt over a period of 20 to 25 years. Each country would also be obliged to introduce a constitutional "debt brake" requiring a balanced budget in future.

The debt repayment pact would stabilise the financial markets, they argue, by offering eurozone members the possibility of covering their current funding needs via the redemption fund. It would accumulate a portfolio of bonds totalling around €2,300bn, in which Italy would hold the largest share – some 41 per cent – followed by Germany with 25 per cent.

There would be an "upward cap" on the amount of debt in the redemption fund after the roll-in phase, with each country obliged to redeem its own debt over 20 to 25 years.

"The joint liability during the repayment phase means that safe bonds would be created, by means of which the European financial system could be stabilised until the national bond markets regain sufficient functionality."

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