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Challenges Facing European Monetary Union

While past discussions on EMU tended to emphasise its role in limiting the impact of the global financial crisis on the euro area countries, the focus has now shifted to the destabilising effects threatening the entire euro zone as a consequence of the dire fiscal situation in some weaker member countries, notably Greece. Will the EMU be able to pass the first serious challenge it faces or is it a fair-weather construction with basic design flaws? What options are available to policymakers?

Daniel Gros and Thomas Mayer

How to Deal with the Threat of Sovereign Default in Europe: Towards a Euro(pean) Monetary Fund*

The case of Greece has ushered in the second phase of the financial crisis, namely that of a public debt crisis. Members of the euro area were supposed to be shielded from a financial market meltdown. But after excess spending during the period of easy credit, several euro area members are now grappling with the implosion of credit-financed construction and consumption booms. Greece is the weakest of the weak links, given its high public debt (around 120% of GDP), compounded by a government budget deficit of almost 13% of GDP, a huge external deficit of 11% of GDP and the loss of credibility from its repeated cheating on budget reports.

Greece – as well as others in the EU, notably Portugal and Spain – must therefore undergo painful adjustments in government finances and external competitiveness if their public debt positions are to become sustainable again. But given the intense pressure from financial markets, it is likely that in some cases a tough fiscal adjustment programme (or rather the promise that one will be forthcoming) might not be enough to avoid a "sudden stop" of external funding of the public sector. When this happens, the euro area will no longer be able to fudge the question of whether (and in what form) it can provide public financial support to one of its members.

One way out of this dilemma seems to be to call in the IMF. In principle, the conditions for taking this route have been clarified at the European Council of 25 March 2010. "As part of a package involving substantial International Monetary Fund financing and a majority of European financing, Euro area member states, are ready to contribute to coordinated bilateral loans. This mechanism, complementing International Monetary Fund financing, has to be considered ultima ratio, meaning in particular that market financing is insufficient. Any disbursement on the bilateral loans would be decided by the euro area member states by unanimity subject to strong conditionality and based on an assessment by the European Commission and the European Central Bank."[1]

However, it is also clear that the IMF would not be able to solve the Greek problem on its own since the amount of financial assistance it could give to the country is limited to about € 10-15 billion, a fraction of Greece's estimated financing need for 2010 alone. This is why the statement from the Heads of State of the Euro Area foresees that the majority of the financing would be European and any disbursement would be decided by euro area member states (by unanimity).

This package which has now been agreed to for the case of Greece is clearly designed to deal with a potential emergency situation in an ad hoc manner.

We would argue, however, that this is not a satisfactory approach in general. The EU needs to design a scheme capable of dealing with the threat of sovereign default. If

* This paper is based on D. Gros, T. Mayer: How to deal with sovereign default in Europe: Towards a Euro(pean) Monetary Fund, CEPS Policy Brief No. 202, Centre for European Policy Studies, Brussels, February 2010.

1 Statement by the Heads of State and Government of the Euro Area, available at http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/113563.pdf

the IMF were called in to help and the country concerned (today Greece, but tomorrow another country) refused to comply with the conditions of a support programme, the problem would only be magnified. The debtor country, like Greece today, would retain its main negotiating asset, namely the threat of a disorderly default, creating systemic financial instability in the EU and possibly at the global level. This dilemma could be avoided by creating a "European Monetary Fund" (EMF), which would be capable of organising an orderly default as a measure of last resort.

Our proposal for an EMF can also be seen as a complement to the ideas presently under discussion for allowing orderly defaults of private financial institutions and rescue funds for large banks that would be funded by the industry itself. The analogy holds in more general terms: in the recent financial crisis, policy has been geared solely towards preventing the failure of large institutions. In the future, however, the key policy aim must be to restore market discipline by making failure possible. For EMU this means that the system should be made robust enough to minimise the disruption caused by the failure of one of its member states.

Purists will object to our scheme on the ground that it violates the "no-bailout" provision of the Maastricht Treaty.[2] However, we would argue that our proposal is actually the only way to make the no-bailout rule credible and thus give teeth to the threat not to bail a country out. The drafters of the Maastricht Treaty had failed to appreciate that, in a context of fragile financial markets, the perceived (and real) danger of a financial meltdown makes a "pure" no-bailout response unrealistic. As with the case of large, systemically important banks, market discipline can be made credible only if there are clear provisions that minimise the disruptions to markets in case of failure.

Key Issues for the Design of a European Monetary Fund

Any mutualisation of risks creates a moral hazard because it blunts market signals. This would argue against any mutual support mechanism and for reliance on financial markets to enforce fiscal discipline. However, experience has shown repeatedly that market signals can remain weak for a long time and are often dominated by swings in risk appetite which can be quite violent. Hence, in reality the case for reliance on market signals as an enforcement mechanism for fiscal discipline is quite weak. In fact, swings in risk appetite and other forces that have little to do with the creditworthiness of a country can lead to large swings in yield differentials and even credit rationing that have little to do with economic fundamentals. The moral hazard problem can never be completely neutralised, but for our proposal it could be limited in two ways: through the financing mechanism of the EMF and via the conditionality attached to its support. These points will be discussed first, followed by a brief analysis of two equally important issues, namely enforcement and orderly default.

2 Article 125 of the TFEU (formerly Article 103 TEC).

Contributors to this Forum

Daniel Gros, Centre for European Policy Studies (CEPS), Brussels, Belgium, and CEPR.

Thomas Mayer, Deutsche Bank.

Ulrich Häde, European University Viadrina Frankfurt (Oder), Germany.

Jean Pisani-Ferry, Bruegel, Brussels, Belgium, and Université Paris-Dauphine, France.

André Sapir, Université Libre de Bruxelles and Bruegel, Brussels, Belgium.

Jürgen Matthes, Cologne Institute for Economic Research (Institut der deutschen Wirtschaft Köln), Germany.

Deborah Mabbett, Birkbeck, University of London, UK, and Hanse Wissenschaftskolleg, Delmenhorst, Germany.

Waltraud Schelkle, London School of Economics and Political Science, London, UK, and Hanse Wissenschaftskolleg, Delmenhorst, Germany.

Wim Kösters, Ruhr Universität Bochum and Rheinisch-Westfälisches Institut für Wirtschaftsforschung, Essen, Germany.

Paul de Grauwe, University of Leuven, Belgium.

Desmond Lachman, American Enterprise Institute (AEI), Washington, DC, USA.

Financing Mechanism

A simple mechanism to limit the moral hazard problem would be to ensure that the main contributions would come from those countries that breach the Maastricht criteria. The contribution rates would be calculated on the following basis:

- 1% annually of the stock of "excess debt", which is defined as the difference between the actual level of public debt (at the end of the previous year) and the Maastricht limit of 60% of GDP. For Greece, with a debt-to-GDP ratio of 115%, this would imply a contribution to the EMF equal to 0.55% of GDP.
- 1% of the excessive deficit, i.e. the amount of the deficit for a given year that exceeds the Maastricht limit of 3% of GDP. For Greece, the deficit of 13% of GDP would give rise to a contribution to the EMF equal to 0.10% of GDP.

Thus, the total contribution for Greece in 2009 would have been 0.65% of GDP.

The contributions should be based on both the deficit and the debt level because both represent warning signs of impending insolvency or liquidity risk (this is also the reason why both were included in the Maastricht criteria and both matter for the Stability and Growth Pact, although in practice the debt ratio has played less of a role). It could be argued that contributions should be based on market indicators of default risk rather than the suggested parameters. But the existence of the EMF would depress CDS spreads and yield differentials among the members of the EMF, making such a procedure impossible.[3] Contributions would be invested in investment-grade government debt of euro area member countries. Debt service (in case funds had to be raised in the market) would be paid from future contributions.

Countries with exceptionally strong public finances would not need to contribute because they would de facto carry the burden should a crisis materialise. Their backing of the EMF (and the high rating of their bonds in the portfolio of the EMF) would be crucial if the EMF were called into action and the accumulated funds were not sufficient.[4] The EMF should thus be given the authority to borrow in the markets to avoid having its accumulated contributions fall short of the funds required to deal with the crisis at hand.

It could be argued that taxing countries under fiscal stress to fund the EMF would only aggravate their problems. However, most contributions would have to be paid on account of moderate debt levels long before a crisis arises.

With the suggested funding mechanism, the EMF would have been able to accumulate €120 billion in reserves since the start of EMU – enough probably to finance the rescue of any of the small-to-medium-sized euro area member states. Of course, this is just an illustrative calculation, since it is highly likely that actual deficits (and hence over time debt levels) would have been much lower, given the price countries would have had to pay for violating the Maastricht criteria.

Concerning the form of intervention, in principle the EMF could provide financial support in one of two ways: it could sell part of its holdings (or raise funds in the markets) and provide the member country with a loan, or it could provide a guarantee for a specific issuance of public debt. The following discussion assumes that the second approach will be pursued.

Conditionality

There should be two separate stages:

Stage I: Any member country could call on the funds of the EMF up to the amount it had deposited in the past (including interest), provided its fiscal adjustment programme has been approved by the management of the Fund (and by the Eurogroup, which would constitute its board).[5] The country in question could thus issue public debt with a guarantee from the EMF for up to this amount.

Stage II: Any drawing on the guarantee of the EMF above this amount would be possible only if the country agrees to a tailor-made adjustment programme supervised jointly by the Commission and the Fund (and thus also the Eurogroup).

3 Something else would reinforce graduated pressure on countries with weak fiscal policies: an adjustment of the risk weighting under Basle II. The risk weight for government debt is at present 0 for governments rated AAA to A, and only 20% until A- (implying that banks have to hold only 0.2*8% = 1.6% of capital against holdings of the debt of governments which might have lost over 10% in value). There is no reason why euro area government debt should have a systematically lower risk weighting than corporate debt, for which the risk weights are 20% and 50%, respectively.

4 An analogy with the IMF illustrates the underlying logic: All countries contribute *pro rata* to the financing of the IMF, which enables it to provide financing to those member countries in need because of balance-of-payments problems.

5 In formal terms this would mean that the country is faithfully implementing its programme and that no recommendation under Article 126.7 has been formulated within the excessive deficit procedure.

With the EMF in operation, a crisis would be much less likely to arise. However, should a crisis arise, the EMF could swing into action almost immediately because it would not have to undertake any large financial operation beforehand. A public finance crisis does not appear out of the blue. A member country encountering financial difficulties will have run large deficits for some time and its situation will thus have been closely monitored under the excessive deficit procedure.

Enforcement

The funding mechanism of the EMF would contain an automatic "enforcement" mechanism of the Maastricht criteria. This automatic aspect is crucial because the experience with the Stability and Growth Pact has shown that, except in extreme cases, it is not possible to get a majority of the club to agree to punish one of its members.

However, there are a range of supplementary enforcement mechanisms in case the country in question does not live up to its commitments in the context of an EMF-sponsored adjustment programme: as a first step, new funding (guarantees) would be cut off. This is standard, but the EU can do much more. Funding under the structural funds could also be cut off (this is already foreseen, in a weak form, under the Stability and Growth Pact). For a country like Greece, this could amount to about 1-2% of GDP annually. Finally the country could effectively be cut off from the euro area's money market when its government debt is no longer eligible as collateral for the ECB's repo operations. The key point here is that these sanctions can be applied in an incremental manner and that they impose considerable economic and political costs on any country contemplating not implementing a previously agreed upon programme.

Orderly Default

The strongest negotiating asset of a debtor is always that default cannot be contemplated because it would bring down the entire financial system. This is why it is crucial to create mechanisms to minimise the unavoidable disruptions resulting from a default. Market discipline can only be established if default is possible because its cost can be contained.

A key advantage of the EMF would be that it could also manage an orderly default of an EMU country that failed to comply with the conditions attached to an adjustment programme. A simple mechanism, modelled on the successful experience with the Brady bonds, could do the trick. To safeguard against systemic effects of a default, the EMF could offer holders of the defaulting country's debt an exchange of this debt with a uniform haircut against claims on the EMF.

This would be a key measure to limit the disruption from a default. A default creates ripple effects throughout the financial system because all debt instruments of a defaulting country become, at least upon impact, worthless and illiquid.[6] However, with an exchange à la Brady bonds, the losses to financial institutions would be limited (and could be controlled by the choice of the haircut).

How drastic should the haircut be? The Maastricht fiscal criteria again offer a useful guideline. The intervention of the EMF could be determined in a simple way: the EMF could declare that it would only be willing to invest an amount equal to 60% of the GDP of the defaulting country. In other words, the haircut would be set in such a way that the amount the EMF has to spend to buy up the entire public debt of the country concerned is equal to 60% of the country's GDP. This would imply that for a country with a debt-to-GDP ratio of 120%, the haircut would be 50%, as the EMF would "pay" only 60/120. Given that the public debt of Greece is now already trading at discounts of about 20% (for longer maturities), this would mean only a modest loss rate for those who bought up the debt more recently. Of course, the size of the haircut is also a political decision that will be guided by a judgement on the size of the losses that creditors can bear without becoming a source of systemic instability. But uncertainty could be significantly reduced if financial markets were given this approach as a benchmark based on the Maastricht criteria.

Moreover, the EMF would exchange only those obligations that were either traded on open exchanges or had been previously registered with the special arm of the EMF dealing with the verification of public debt figures. This means the obligations resulting from secret derivative transactions would not be eligible for the exchange. This would be a strong deterrent against using this type of often murky transaction with which governments try to massage their public finances. The financial institutions that engage in these transactions would know that in case of failure, they would be last in line to be rescued and would thus become much less interested in proposing and executing them. Especially in times of crisis, all creditors would have a strong incentive to come forward to register their claims on the government in financial difficulties. At present, the opposite seems to be the case.

6 For more on default risks, see M. Biggs, P. Hooper, T. Mayer, T. Slok, M. Wall: The Public Debt Challenge, Deutsche Bank Global Markets Research, January 2010.

The financial institutions that concluded these derivative transactions are only interested in covering up the role they played in hiding the true state of the public finances of the countries now facing difficulties.

In return for offering the exchange of bona fide public debt against a haircut, the EMF would acquire all the claims against the defaulting country. From that time onwards, any additional funds the country received could be used only for specific purposes approved by the EMF. Other EU transfer payments would also be disbursed by the EMF under strict scrutiny, or they could be used to pay down the debt owed by the defaulting country to the EMF. Thus, the EMF would provide a framework for sovereign bankruptcy comparable to the Chapter 11 procedure existing in the USA for bankrupt companies that qualify for restructuring. Without such a procedure for orderly bankruptcy, the Community could be taken hostage by a country unwilling to adjust, threatening to trigger a systemic crisis if financial assistance was not forthcoming.

Member states of the EU remain sovereign countries. A defaulting country may regard such intrusion into its policies by the EMF as a violation of its sovereignty and hence unacceptable. But an E(M)U member country that refused to accept the decisions of the EMF could leave the EU, and with this, EMU,[7] under Article 50 of the Treaty.[8] The price for doing so would of course be much greater than that exacted in the case of the default of Argentina.

Concluding Remarks

We argue that setting up a European Monetary Fund to deal with euro area member countries in financial difficulties is superior to the option of muddling through on the basis of ad hoc measures, like the ones taken by the European Council in February and March of this year. Without a clear framework, decisions about how to organise financial support typically have to be taken hurriedly, under extreme time pressure, and often during a weekend when the turmoil in financial markets has become unbearable.

We see two key advantages of our proposal: first, the funding of the EMF should give clear incentives for countries to keep their fiscal house in order at all times. Secondly, and perhaps even more importantly, the EMF could provide for an orderly sovereign bankruptcy procedure that would minimise the disruption resulting from a default.

Both these features would decisively lower the moral hazard problem that pervades the present situation in which both the markets and the Greek government assume that, in the end, they can count on a bailout because the EU could not contemplate the bankruptcy of one of its members. *We should by now have learned that the best way to prevent failure is to prepare for it.*

We have concentrated in this contribution on the key policy functions for the EMF and have neglected other aspects, such as its organisational and legal form. It would of course be indispensable to give the EMF a professional staff able to operate independently from politics, much like the IMF. However, solutions for these organisational and legal issues can be found if there is consensus on the basic policy issues. Reaching such a consensus should be the main aim of the task force of government representatives instituted by the European Council of March.

Our proposal is not meant to constitute a "quick fix" for the specific case of Greece. The country has deep-seated problems which will take years to address properly. Nonetheless, if the EMF were to be set up within the next 12 months, it might still come in time to provide a clearer framework even for this case. However, our main concern is to prepare the euro area for the coming decades, which are likely to be characterised by a generalised deterioration in public finances throughout the EU, given the joint effects of ageing and lower growth. Other problem cases are thus likely to arise sooner rather than later. The experience of Argentina shows that default arises only after a lengthy period of several years in which economic and political difficulties interact and reinforce each other. Failure is not inevitable, as the relatively successful experience so far with tough adjustment programmes in Ireland and Latvia shows. But what is unavoidable is a considerable period of uncertainty. With an EMF, the EU would be much better prepared to face these difficult times.

7 For the legal issues surrounding a withdrawal from the euro area, see P. Athanassiou: Withdrawal and expulsion from the EU and EMU: Some reflections, ECB Legal Working Paper No. 10, ECB, Frankfurt, December 2009, http://www.ecb.int/pub/pdf/scplps/ecblwp10.pdf.

8 Article 50 of TEU:
1. Any Member State may decide to withdraw from the Union in accordance with its own constitutional requirements.
2. A Member State which decides to withdraw shall notify the European Council of its intention. In the light of the guidelines provided by the European Council, the Union shall negotiate and conclude an agreement with that State, setting out the arrangements for its withdrawal, taking account of the framework for its future relationship with the Union. That agreement shall be negotiated in accordance with Article 218(3) of the Treaty on the Functioning of the European Union. It shall be concluded on behalf of the Union by the Council, acting by a qualified majority, after obtaining the consent of the European Parliament.

Ulrich Häde*

Legal Evaluation of a European Monetary Fund

Daniel Gros and Thomas Mayer have suggested establishing a European Monetary Fund (EMF).[1] It could, under certain conditions, financially support Member States of the European Union that have already introduced the euro.

The Proposal by Gros and Mayer

In detail, the proposal provides for the financing of the EMF through contributions (in terms of penalties) from those States that do not comply with the budgetary discipline as laid down in Union law.[2] Only those Member States that do not meet the reference values for government debt (60% in relation to GDP) and for the budgetary deficit (3% in relation to GDP) would be required to make a payment. Moreover, the Fund shall be allowed to borrow money. If a Member State encounters financial difficulties, it could, upon submission of an adjustment programme, call on the guarantees of the Fund in an amount equivalent to its previously deposited contributions. Additional drawings would be possible only if the State agreed to further conditions and financial budgetary disciplinary restraint.

In case the financial support provided by the Fund does not suffice, Gros and Mayer have suggested rules to make an orderly sovereign default possible. Currently, no such procedure exists. Thus, the insolvency of one State would have incalculable consequences for other Member States, giving it a certain potential for extortion. According to the proposal, the European Monetary Fund shall guarantee an amount equivalent to 60% of the GDP of a Member State, which would make sovereign default a manageable risk.

Legitimacy

Ultimately, politicians and economists will have to determine whether these considerations are politically useful. This article discusses only the legal aspects of such a Fund, in particular to determine whether the proposal could be realised in accordance with current Union law.

Enhanced Cooperation

Gros and Mayer assume that the proposed EMF could be implemented within the framework of enhanced cooperation, a concept introduced into European law by the 2001 Treaty of Nice. In current Union law this enhanced cooperation is identified in Art. 20 of the Treaty on European Union (TEU) and in Art. 326 ff. of the Treaty on the Functioning of the EU (TFEU). Should the Council establish that the implementation of the Union's objectives will not be attained within a reasonable period of time by the Union as a whole, as a last resort it can authorise enhanced cooperation in this area by a group of at least nine Member States, enabling those Member States to proceed more quickly. Nevertheless, participation must be open to every other State which complies with any conditions laid down by the authorising decision.

Presumably the 16 States of the euro area can be regarded as such a group that has agreed on enhanced cooperation in the form of the establishing of the European Monetary Fund. However, none of these States would be obliged to do so; participation in enhanced cooperation is optional. Besides, according to Art. 326 TFEU enhanced cooperation has to comply with the Treaties and Union law. Thus, deviations from the primary law of the Union as laid down in the TEU and the TFEU would be illegal. Consequently, in the context of enhanced cooperation it would only be possible to pursue steps toward integration that are already provided for in primary law. Measures that required a revision of the Treaties could therefore not be implemented.

At any rate, recourse to the instrument of enhanced cooperation within the field of the European Economic and Monetary Union (EEMU) may be neither necessary nor admissible. The EEMU is a special form of differentiated integration that is already laid down in the primary law of the Union. Since 1999, 16 Member States have in-

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* Translation by Robert Böttner, student assistant at the Chair for Public Law, International Public Law and European Integration, University of Erfurt, Germany.

1 D. Gros, T. Mayer: How to deal with sovereign default in Europe: Towards a Euro(pean) Monetary Fund, CEPS Policy Brief No. 202, February 2010. See also T. Mayer: The Case for a European Monetary Fund, in: Intereconomics, Vol. 44, No. 3, 2009, p. 138. See also the contribution by D. Gros and T. Mayer in this Forum.

2 Art. 126 of the Treaty on the Functioning of the European Union in conjunction with the Protocol (No. 12) on the excessive deficit procedure.

troduced the euro after it had been (justly or unjustly) verified that they had met the requirements to do so. The detailed regulations of Art 119 ff. TFEU concerning the EEMU provide for intensified cooperation among a group of Member States within the field of monetary policy while excluding the other Member States. There would be no room for enhanced cooperation within the meaning of Art. 326 ff. TFEU, for it would not be permitted to deviate from those provisions of primary law.

One option could be recourse to Art. 136 TFEU, originally introduced by the Lisbon Treaty. In its first paragraph it authorises measures to strengthen the coordination and surveillance of the budgetary discipline of those States using the euro as their currency. But again, these measures have to be compatible with established primary law. Likewise, the so-called "lacuna-filling competence" of Art. 352 TFEU does not permit deviations from the provisions on the EEMU. Thus, establishing the European Monetary Fund is only admissible if it does not conflict with the primary law of the Union.

Compatibility with Art. 126 TFEU

The financing mechanism of the EMF suggested by Gros and Mayer ties in with the budgetary discipline as laid down in Art. 126 TFEU. Paragraph 1 of Art. 126 TFEU obliges the Member States to avoid excessive government deficits. The decisive criterion for a sustainable fiscal policy is compliance with the reference values for government debt and budgetary deficit. If Member States using the euro currency fail to comply with this budgetary discipline, then in accordance with paragraph 11 of Art. 126 TFEU, the Council can impose sanctions which, in the worst case, would be high fines.

The EMF shall be financed through payments from those States that do not meet the reference values. In this respect, the question that arises here is whether those further consequences in addition to the sanctions of paragraph 11 of Art. 126 TFEU would be legally permissible. One argument against this is that paragraph 2 of Art. 126 TFEU does permit an exceeding of the reference values in certain cases. Details are laid down in Council Regulation 1467/97, which is an element of the Stability and Growth Pact. Actually, the sanctions of Art. 126 TFEU are not tied to the mere exceeding of the reference values, but instead to the formal decision proclaiming the existence of an excessive deficit. Paragraph 1 of Art. 140 TFEU proceeds in the same way. A Member State can introduce the euro only if there is no Council decision proclaiming the existence of an excessive deficit.

It would amount to a break in the system if the mere exceeding of the reference values were sanctioned. Besides, the enumeration of sanctions due to a violation of the budgetary discipline in paragraph 11 of Art. 126 TFEU is exhaustive. Thus, there may not be any justification for penalty payments in addition to the fines provided for due to a violation of the budgetary discipline. It therefore seems questionable whether Art. 4 of the Council Regulation (EC) No. 1084/2006 of 11 July 2006 establishing a Cohesion Fund[3], which allows for the suspension of the financing of projects by the Cohesion Fund if the Council has decided that an excessive public deficit exists, is compatible with Art. 126 TFEU. Even more so, Art. 126 TFEU does not permit payment obligations in terms of contributions to the EMF. The proposed financing mechanism could therefore not be realised without Treaty revision.

Compatibility with Art. 125 TFEU

Paragraph 1 of Art. 125 TFEU excludes the Union and the Member States from liability for the commitments of another Member State. This "no bail-out" clause is the key argument in the current debate on support for euro area members that encounter difficulties. Not only does the provision prohibit the assumption of a Member State's debts, it also rules out EU liabilty for such commitments. This means that any measure equivalent to liability shall be prohibited. Hence, it would also apply to Gros and Mayer's proposed guarantees for public debts. Even more so, payments to the creditors of the insolvent State within the orderly insolvency proceedings would not be compatible with paragraph 1 of Art. 125 TFEU. Thus, it would be legally inadmissible for the Union or a fund established by the Union to assume the debts of Member States, even on a limited basis.

Compatibility with Art. 122 TFEU

A legal evaluation based only on Art. 125 TFEU would, however, be incomplete; one must also consider Art. 122 TFEU. This provision calls not only for political but also for financial solidarity with Member States that are in severe difficulties. Paragraph 2 of Art. 122 TFEU authorises the Council to grant financial assistance from the Union to a Member State. This requires that the Member State in question is currently in, or is seriously threatened with, severe difficulties caused by natural disasters or exceptional occurrences beyond its control.

A highly indebted State that is in difficulties due to a lack of discipline in budgetary policy does not, of course, face

3 O.J. L 210/79 (2006).

a natural disaster. But a self-inflicted budgetary situation, in combination with a global financial crisis of historic dimensions that caused a significant decrease of the GDP, can also be qualified as an exceptional occurrence. When a Member State loses control over the situation because it can no longer help itself, the second requirement of paragraph 2 of Art. 122 TFEU is met. A third element is that the State has to be affected by, or threatened with, severe difficulties in the sense of serious damaging effects on the economy. There is definitely no doubt about that if there is an immediate threat of national bankruptcy.

When the conditions of the aforementioned elements are present, the legal consequence applies: the Council may grant Union financial assistance, but only "under certain conditions". Hence, the Union has to connect its support to constraints that aim towards the elimination of the difficulties in order to enable the Member State to regain control over the situation.

Given this background, it becomes evident that paragraph 2 of Art. 122 TFEU forms a thus far underestimated legal basis. On the other hand, Art. 125 TFEU prohibits an assumption of the commitments of a Member State. The conflict between Art. 125 and Art. 122 TFEU cannot be solved by ignoring Art. 122. If the requirements of both articles are met, it is not about suppression but about harmonisation. These two contrary provisions reflect the differing points of view of the economically stronger and weaker Member States during the negotiations on the Maastricht Treaty. The former wanted to exclude any possible behaviour that would contradict stability, while the latter supported a mechanism that contained solidarity. The final version of the Treaty did not clearly decide for one or the other option but rather put them alongside each other; thus each group could claim to have prevailed. In reality the conflict was merely postponed – a typical European compromise.

If one tries to harmonise both provisions, Art. 125 TFEU cannot completely preclude financial assistance. Thus, a procedure equivalent to a bail-out can, as an exception, be admissible.[4] Nonetheless, such measures can only be taken into account as *ultima ratio* if there are no other means available to prevent a severe crisis and only under accordingly strict conditions. Besides, it must be clear that financial assistance is just one of the Union's options. An enforceable claim to any such support by the Member State in question would compromise the exclusion of liability in Art. 125 TFEU and must thus be rejected.

4 For details see U. Häde: Staatsbankrott und Krisenhilfe, in: Europäische Zeitschrift für Wirtschaftsrecht (EuZW), 2009, pp. 273 ff.

Bilateral financial aid from the Member States alongside the Union's support would likely be inadmissible. Art. 125 TFEU excludes a bail-out by both the Union and the Member States while paragraph 2 of Art. 122 TFEU applies only to the Union; there is no provision for such an exception for the Member States. Thus, one can assume that the Contracting Parties wished to give the right to a deviation from Art. 125 TFEU to the Union only.

Consequences for the EMF

What does this mean for the European Monetary Fund? Under the conditions outlined, paragraph 2 of Art. 122 TFEU can serve as a legal basis for support to a Member State that is threatened by national bankruptcy. It might even be possible to lay down the conditions for the aid, the procedure for granting financial assistance and the possible prerequisites for that assistance in a regulation. For Member States outside the euro zone, Art. 143 TFEU permits mutual assistance with regard to difficulties in the balance of payments. In this context, the Council has based its Regulation (EC) No. 332/2002 of 18 February 2002 establishing a facility providing medium-term financial assistance for Member States' balances of payments[5] on the "lacuna-filling competence" of Art. 308 EC. It should thus be possible to adopt a regulation for the aforementioned operationalisation of financial assistance according to paragraph 2 of Art. 122 TFEU on the basis of the successor provision, Art. 352 TFEU. This regulation could include elements of the proposal by Gros and Mayer or other ideas on the design of an EMF which have been published in the meantime.

Nevertheless, parts of the current proposal could not be implemented under established Union law. Granting a legal claim to the Member State in danger, thereby entitling it to guarantees from the Union, would not be possible. Besides, financing the Fund via contributions from those Member States that exceed the reference values for government debt and the budgetary deficit would not be compatible with Art. 126 TFEU. Any other deviation from the procedures laid down in the TFEU (e.g. voting rights limitations that are not provided for, participation of the ECB) or even expulsion from the Monetary Union would also only be feasible by amending the Union Treaties.

Procedure for Amendment of the Treaties

For the amending of provisions on the internal policies of the Union in Part Three of the TFEU, the simplified revision procedure could apply. According to paragraph 6 of Art. 48 TEU, the right of initiative lies with the Government

5 O.J. L 53/1 (2002).

of any Member State, the European Parliament and the Commission. They can submit the relevant proposals to the European Council, which must decide unanimously. The entry into force then depends on approval by the Member States in accordance with their respective constitutional requirements.

However, the simplified revision procedure only applies if the proposed Treaty revision does not lead to an increase in Union competences. A narrow interpretation of this concept which sees it only as the conferral of additional policy areas from the Member States to the Union might accept that the proposal for the establishing of an EMF does not increase Union competences. On the other hand, a broad interpretation could regard the additional possibilities for the Union to intervene in the overall economic and fiscal policy that had thus far been reserved for the Member States as an increase in competences. Because paragraph 6 of Art. 48 TEU has only been in force since 1 December 2009, there is no practical experience to draw on; thus, uncertainties remain.

If one assumes an increase in the competences conferred on the Union, then the ordinary revision procedure would have to be applied. Hence, according to paragraph 3 of Art. 48 TEU, a convention composed of representatives of the national Parliaments, of the Heads of State or Government of the Member States, of the European Parliament and of the Commission would have to be convened. However, the European Council could, after obtaining the consent of the European Parliament, decide to avoid a convention due to the limited extent of the proposed amendments and instead convene a conference of representatives of the governments of the Member States. The results of the convention or of the intergovernmental conference would then need to be ratified by all Member States before they could enter into force.

Jean Pisani-Ferry and André Sapir

Crisis Resolution in the Euro Area: An Alternative to the European Monetary Fund

What should have been a relatively limited Greek crisis which might have been resolved by fairly technical means has turned into a crisis of the euro area, requiring a political response by the European Council. Only time will tell whether the agreement reached on 25 March will endure and whether the ambiguities that remain in it will prove serious or benign. But what is already clear is that the management of this crisis has involved gestures of major symbolic and political significance.

The reason for this situation is not, contrary to fears often expressed by markets and commentators, that the Greek case is the tip of the iceberg of a wider problem affecting all the PIIGS or GIPSY countries, as Greece, Ireland, Italy, Portugal and Spain are often collectively referred to. Although all these countries clearly face significant economic challenges, these challenges are not identical and none of the countries is confronted with a crisis anywhere close to the one facing Greece, which is unique in its repeated violation of EU budgetary rules.

The reason the Greek situation has been elevated into a euro area crisis lies, instead, in the fact that it has exposed a double inadequacy of economic governance in the euro area: first, the provisions of the Treaty and of the Stability and Growth Pact (SGP), which were designed to prevent a budgetary crisis, have not been enforced; second, the failure to include crisis management and resolution principles in the Treaty, partly out of fear that their very existence might induce a much dreaded budgetary crisis, has proved detrimental.

It is natural, therefore, that the debate about the crisis, which began with a discussion on how to resolve the Greek crisis, has evolved into a wider argument over the governance of the euro area, in particular regarding crisis prevention and crisis resolution. An important contribution in this respect came from Gros and Mayer,[1] who proposed the creation of a European Monetary Fund (EMF).

The EMF Proposal

The EMF proposed by Gros and Mayer is meant to address both the crisis prevention and crisis resolution deficiencies of the current system. Countries that violate the Maastricht debt limit of 60 per cent of GDP and deficit ceiling of 3 per cent of GDP would have to make financial contributions to

1 Daniel Gros, Thomas Mayer: Towards a Euro(pean) Monetary Fund, CEPS Policy Brief No. 202, February 2010.

the EMF. This would have the double virtue of creating additional incentive to respect the Maastricht rules and generating resources that could be mobilised to resolve a crisis, should such a situation reappear. According to the authors, the creation of the EMF would be a concrete expression of the principle of solidarity enshrined in the Treaty – not of solidarity from countries that respected the rules to countries that violated the rules and find themselves in budgetary crisis as Greece does at the moment, but rather from the latter to the former. The EMF would be designed to prevent budgetary difficulties in one country from spilling over to other euro area members. It would, therefore, reinforce the SGP and provide self-insurance to delinquents. In addition, a major benefit of the EMF, according to Gros and Mayer, is that it would be capable of organising an orderly default as a measure of last resort. This would remove the risk of disorderly default, which is the main threat that countries in a fiscal crisis pose to the systemic financial stability of the euro area.

The Gros-Mayer proposal was broadly endorsed by the German government, including by German Finance Minister Wolfgang Schäuble, who has sought ways of making the euro area more resilient to a crisis in view of the Greek dilemma.

Schäuble acknowledges that the Greek crisis has revealed "that the European body of regulations is still incomplete. Monetary union is unprepared for extremely severe situations of the type we are now seeing and that demand a comprehensive intervention to avert greater systemic risks. In the faith that budget surveillance was effective, the disequilibrium today was held to be inconceivable."[2] This calls for further integration in the euro area, specifically for the creation of a crisis management and resolution mechanism.

Among the various options for further integration, the German Finance Minister endorsed the idea of a European Monetary Fund to reduce the risk of defaults. He added, however, that should a euro area country find itself unable to consolidate its budgets or restore its competitiveness despite EU aid, it "should, as a last resort, exit the monetary union while being able to remain a member of the EU". In doing so, the German government broke with what is generally considered to be a taboo in the European debate.

A serious problem with the Gros-Mayer proposal is that it puts the entire onus of crisis resolution on delinquent countries, with no mutual assistance from other EU (or euro area) countries. The Schäuble approach probably provides for mutual assistance, but at a price: expulsion from the euro area in case assistance is judged unsuccessful. Neither solution, therefore, passes the test of "Community spirit" – or, to put it more simply, of cooperation between countries in the general interest.

Furthermore, to make only delinquent countries pay for assistance would be politically untenable. Sooner or later the payers would claim posession of the fund and deny any right in deciding how to use it to those who had not contributed to it. The two aims of strengthening the hand of the virtuous countries and of making the non-virtuous pay for assistance are mutually incompatible.

Involvement of the IMF

A better approach would be to seek a solution based on existing treaties, as proposed by Marzinotto, Pisani-Ferry and Sapir.[3]

In 2008 and 2009, three EU countries faced with budgetary crises – Hungary, Latvia and Romania – turned to the International Monetary Fund (IMF) for financial assistance. Along with a conditional IMF loan, these countries received a Community conditional loan under the medium-term financial assistance (MTFA) facility set up to help EU countries with balance of payments (BoP) difficulties.

Euro area countries belong to the IMF and therefore retain the possibility of obtaining financial assistance from it. However, they are not eligible for Community MTFA since Article 143 of the Lisbon Treaty explicitly reserves such assistance to Member States "with a derogation", i.e. those outside the euro area. This clause has often been interpreted in recent discussions about Greece as one facet of the Treaty prohibition on bailing out euro area countries with budgetary problems. However, such an interpretation is plainly wrong.

The Treaty contains a no-bailout clause in its Article 125, which explicitly states that the Union and individual Member States cannot "be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any (other) Member State". This principle, which was introduced in the EU Treaty at the time of Maastricht, is an essential pillar of EMU. It is clear and sound and should remain untouched.

2 Wolfgang Schäuble: Why Europe's monetary union faces its biggest crisis, Financial Times, 12 March 2010.

3 Benedicta Marzinotto, Jean Pisani-Ferry, André Sapir: Two Crises, Two Responses, Bruegel Policy Brief 2010/01, March 2010.

Article 143 is totally different. It is not about the Union or any Member State *assuming liabilities* of another Member State, but rather about *granting a loan* to a Member State facing a BoP problem. This article derives from Article 109h of the Maastricht Treaty (later renumbered Article 119), which itself derives from Article 108 of the 1957 Treaty of Rome. The only substantive difference between Article 108 and the later versions is the distinction between Member States with a derogation (and therefore not participating in the third stage of EMU) and the others. Why was this distinction introduced in Maastricht? Why are euro area members ineligible for BoP mutual assistance in the form of conditional loans?

The short and complete answer is simply that euro area members were not meant to have BoP problems. The exclusion of euro area members from BoP mutual assistance is purely the consequence of what was considered to be self-evident at the time of Maastricht. It has nothing to do with the no-bailout clause, as many assume today. That our interpretation is correct is attested to not only by many persons who were involved in the Maastricht Treaty negotiations but also by several Community documents.

The original machinery for MTFA in case of BoP difficulties was set up by a Council Decision of March 1971. Like Article 108 of the Rome Treaty on which it is based, the Decision makes no reference to monetary union and, therefore, no distinction between members and non-members of such a union. The MTFA was revised by a Council Regulation of June 1988, three years *before* the Maastricht Treaty was concluded but ten years *after* the creation of the European Monetary System (EMS). The 1988 Regulation clearly specifies that "the financing obligations on Member States under the machinery for medium-term financial assistance [should] remain in force until the final stage of the European Monetary System", i.e. until the creation of monetary union. This echoes the view by the 1970 Werner Report that "[i]n such [monetary] union, all that matters is the global balance of payments vis-à-vis the outside world."

The Greek crisis clearly has proved that BoP problems can also arise in euro area countries. Obviously, Greece does not have a foreign exchange problem, but it nonetheless has a BoP problem in the sense that it has a large current account deficit and that the financing of its public debt relies heavily on foreign investors. This example shows that the exclusion of euro area countries from Community BoP assistance is not warranted – at least not on the basis of Maastricht.

Confusion between a bailout and conditional mutual assistance/non-assistance has been one of the damaging features of the recent European discussion on crisis management. This should be remedied by sticking to the no-bailout principle while putting into place a clear and predictable conditional mutual assistance regime.

The question then is who should be in charge of crisis management in the euro area? The IMF, the EU, or both together?

A Framework for Joint EU-IMF Assistance

A purely IMF-based approach is undesirable because it would risk creating incompatibility between IMF and EU policy requirements. Whereas the IMF has full leeway when negotiating a programme with a country that is not part of a regional arrangement, EU members (and especially euro area members) are part of a policy system that needs to be taken into account when designing a programme.

A purely EU-based solution would also have problems. First, it would amount to creating an entirely new legal and financial apparatus. IMF conditional assistance rests on specific agreements, procedures and instruments that do not exist in the EU. This is why the EU relies on joint programmes with the IMF for providing assistance to its non-euro members: it makes good sense for the European Commission to benefit from the IMF's extensive worldwide experience. The second problem is that EU loans under the balance-of-payments programme are financed exclusively by funds raised by the EU on capital markets. These EU bonds are, however, fully guaranteed by the EU budget. As long as the sums involved are relatively small, as in the case of Hungary, Latvia and Romania, the tiny size of the EU budget is not a severe constraint. The matter would be entirely different if larger EU countries needed assistance.

These considerations call for establishing a framework for joint EU-IMF assistance to countries in the euro area. A solution of this sort could also serve as a model for IMF agreements with other regional groupings, not least the Asian Chiang Mai initiative, and could help make cooperation between the IMF and such groupings more effective and efficient.

On this basis, Marzinotto, Pisani-Ferry and Sapir[4] make a two-pronged recommendation:

- *Extending Article 143 to euro area countries*. It would be desirable to modify Article 143 so that the EU conditional loan facility can be made available to euro area members facing financing difficulties. Loans could still be granted, as has always been the case with MTFA

4 Ibid.

loans[5], as part of a package of aid put together with the IMF, a possibility that Article 143 makes explicit.

- *Defining a framework for joint IMF-EU assistance to euro-area members*. This framework should outline the principles and procedures for cooperation and, in particular, make clear that the conditions set out by the IMF for assisting a euro area member have to be consistent with euro area rules and procedures.

The statement by the heads of state and government of the euro area adopted on 25 March in response to the Greek crisis suggests an approach along the lines suggested here, but with an important qualification.

The statement specifies that crisis resolution in the euro area will involve a mechanism involving both the IMF and euro area countries and that "[d]ecisions under this mechanism will be taken in full consistency with the Treaty framework and national laws".[6] The mechanism, therefore, is not an EU-wide mechanism but an ad-hoc mechanism involving only euro area countries. Nor does it involve the creation of a multilateral facility akin to the MTFA facility. It relies instead on bilateral loans by euro area countries, the disbursement of which "would be decided by the euro area member states by unanimity subject to strong conditionality and based on an assessment by the European Commission and the European Central Bank."[7]

Whether or not this facility will evolve towards a multilateral facility akin to the MTFA facility, and if so whether it would involve all EU members or only euro area countries, remains to be seen.

5 There have been only six instances of medium-term financial assistance to EU countries: Italy (1974), Greece (1991), Italy (1993), Hungary (2008), Latvia (2009) and Romania (2009).

6 Council of the European Union (2010), Statement by the Heads of State and Government of the Euro Area, 25 March.

7 Ibid.

Jürgen Matthes

The IMF is Better Suited than an EMF to Deal with Potential Sovereign Defaults in the Eurozone

In the face of the Greek fiscal crisis and in reaction to the plight of the given institutional framework, EMU had to hammer out a new approach to avoid a sovereign default by Greece. Initially the strategy consisted of two parts. First, some "constructive ambiguity" was offered to calm financial markets by vaguely announcing first in February 2009 and then again in February/March 2010 that EMU countries would stand by to help Greece in the case of an imminent insolvency.[1] And second, this potential support was combined with a tightening of the SGP procedures for Greece, which would then include continuous reporting and, effectively, a partial loss of sovereignty. This approach has more or less failed, leading EMU countries to decide on March 25, 2010 to involve the IMF in a potential future financial support programme for Greece.

The failure of the initial approach was not absolute. Greece has enacted several significant fiscal consolidation packages in the meantime, and the interest-rate spreads on Greek government bonds have moderated somewhat – most likely a combined effect of the Greek reform efforts and the announced support measures. Moreover, contagion to other EMU countries has been contained.

However, several weaknesses led to the strategic change. The "ambiguity" clearly laid bare the absence of institutional mechanisms to deal with the threat of a Greek default as well as the lack of agreement among EMU countries on how to proceed. Further problems also hindered the initial approach. First, prominent EU politicians promised Greece financial support if necessary, sometimes however without clearly insisting that Greece continue its fiscal austerity programme. This situation posed a dilemma particularly for Germany. Germany resisted a rescue package without strict and continuous enforcement of fiscal austerity. But if Greece had come close to a default, Germany would have had no choice but to participate in a financial support programme in the name of European solidarity – even if fiscal discipline was not guaranteed. Thus, in contrast to the period before the Maastricht Treaty, when Germany could still threaten to abstain from the EMU project, the country had manoeuvred itself into a position where it had hardly any leverage to push for sufficient und continuous fiscal discipline in Greece. This is why Germany changed its mind and advocated the involvement of the IMF.

Second there was the danger that the tightening of the SGP procedures would eventually fail. This would have been conceivable if the foreseeable rising political resistance in Greece were to be increasingly directed against the EU Commission and possibly also against Germany:

- Either the enforcement of the SGP procedures by EMU partner countries would in such circumstances lead to severe political disruptions within EMU and the EU.

- Or, in view of such political pressures, EMU countries would retreat from their reform requirements that Greece must strictly consolidate its government finances. In this case, the issue of moral hazard, i.e. of bailing out and eventually rewarding a fiscally profligate country, would re-emerge with full force.

The Main Issue: Credibility and Time Inconsistency

This dilemma highlights the grave underlying problems of credibility and time inconsistency which are relevant with regard to several pillars of EMU's institutional framework and which are rooted in the political and cultural fragility of EU integration.

More concretely, the threat of continuously enforcing strict fiscal discipline no longer appears credible in times of large-scale protests directed against EMU institutions or other EMU countries. The same applies to the SGP and the no-bailout clause. The SGP's threat to impose sanctions is counterproductive and also not credible if a county is in a deep fiscal crisis.[2] The no-bailout clause has also not weathered the reality test.[3] There are several reasons for this:

- From the viewpoint of the EU's founding principle of solidarity, it appears politically and diplomatically inconceivable to let Greece default. This would most likely lead to immense economic damage which would potentially be regarded as a burden disproportionate even to the Greek fiscal profligacy.

- In the case of a sovereign default of Greece, contagion could spread to Portugal, Spain, Italy and Ireland, countries that, like Greece, are suffering from a combination of fiscal strains as well as losses of international competitiveness.[4]

- Moreover, the balance sheets of European banks and insurers would suffer considerable losses on government bonds of the respective countries – which could significantly aggravate the distress in financial markets again.

Thus, any affirmation of the no-bailout clause not to help Greece in the case of need is time-inconsistent and thus simply not credible.

The Political Vulnerability of EU Integration

It is important to understand that one important underlying reason behind the problem of time-inconsistency is the political and cultural vulnerability of European integration. The historical geopolitical motivation for EU integration to secure peace among formerly war-torn countries has gradually receded over time. It has made way for a more egocentric approach of many Europeans, who tend to focus on their own economic advantages from EU integration. Furthermore, due to the ever increasing scope of EU regulations, the image of "Brussels" has suffered over time.

Under these preconditions, the envisaged strict enforcement of fiscal austerity in Greece by the European Commission is likely to cause several conflicts that could eventually undermine political and cultural cohesion among EMU countries:

1 The legal issue, whether and under which conditions such a support would conform with EU law is not considered in detail here. It is often said, that any support package would potentially violate the no-bailout clause of Article 125 of the Treaty on the Functioning of the European Union (formerly Article 103 EC-Treaty). The legal interpretations are not clear-cut, but a way around this rule could be opened up by Article 122 (formerly Article 100 EC-Treaty). Article 122, 1 refers to the "solidarity between Member States" and allows for "measures appropriate to the economic situation". Remarkably, it has been newly inserted in the Lisbon Treaty. Article 122, 2 refers to member states "in difficulties" or "seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences beyond its control" and allows "under certain conditions" for "financial assistance to the Member State concerned". As exceptional circumstances either the impact of the financial crisis could be put forward which has – even in the case of Greece – considerably worsened the fiscal situation, or speculators in financial markets could be blamed. Similar views are expressed by Paul de Grauwe: The Greek crisis and the future of the Eurozone, 11 March 2010, Eurointelligence, http://www.eurointelligence.com/article.581+M56693ac617c.0.html; and by Christian Tietje: Akropolis Adieu? – Möglichkeiten und Grenzen des Rechts im Falle eines (drohenden) Staatsbankrotts, in: Ifo Schnelldienst, Vol. 63, No. 4, 2010, pp. 16-20.

2 Moreover, the SGP was weakened in 2005 and was unable to prevent the fiscal profligacy of Greece, see Deutsche Bundesbank: The changes to the Stability and Growth Pact, in: Monthly Report, Vol. 57, No. 4, Frankfurt a.M. 2005, pp. 15-21.

3 Still, there are many voices calling for EMU countries to stick to the no-bailout clause; see e.g. Wim Kösters: Common Euro Bonds – No Appropriate Instrument, in: Intereconomics, Vol. 44, No. 3, 2009, pp. 135-138; Juergen Stark, quoted in Financial Times: Stark words on Greece, 6 January 2010, http://blogs.ft.com/money-supply/2010/01/06/stark-words-on-greece/.

4 See e.g. Juergen Matthes: Ten years EMU – Reality test for the OCA-endogeneity hypothesis, economic divergences and future challenges, in: Intereconomics, Vol. 44, No. 2, 2009, pp. 114-128.

- As already mentioned, strong political resistance could arise to "Brussels" and potentially also to "Berlin" – where traditionally the hawks of European economic stability and the guardians of fiscal austerity are said to reside. The strikes in Greece and other countries do not bode well in this respect.

- Strictly disciplining Greece (and possibly other Mediterranean countries) would potentially deepen the political and economic cleavage between northern and southern EMU countries and could eventually even incite cultural animosities.

- EU integration could also be endangered from the perspective of northern Europeans if taxpayers in these countries were forced to bail out Greece (and maybe also other countries). This would be all the more problematical if the loans were not repaid in full – which is easily imaginable if strict fiscal consolidation cannot be enforced in the face of anti-EU protests.

Together these potential effects pose a considerable threat to the spirit of European integration.

In view of this deadlock, many reform proposals have been brought forward[5] and thoroughly scrutinised.[6] Among them, one suggestion has become particularly popular in political circles in EMU countries.

Evaluating the Proposed European Monetary Fund

To solve the problem of a possible sovereign default in EMU, the creation of a European Monetary Fund (EMF) has been proposed. The EMF should function along the lines of the IMF, but should be financed and governed by EMU countries alone.[7]

The basic idea behind an EMF appears worth considering at first glance. This institutional innovation is intended to fill the above-mentioned gap in EMU's governance framework, because it would be able to deal with impending sovereign defaults by providing support packages, while at the same time imposing reform conditions in order to correct fiscal imbalances. However, for several reasons this approach does not appear commendable.

First and foremost, the EMF would face the same problems of time-inconsistency of its conditionality that would generate the same lack of credibility as the instruments analysed above. Once again EMU countries would – probably in vain – try to enforce strict reform conditions in the face of foreseeable strong protests against the EMF and against fiscally austere EMU countries. Moreover, it is unlikely that from the outset reform conditions will be sufficiently strict, as other countries which could come under the auspices of the EMF would be represented on the board of the EMF. The problem of potential sinners having to judge other sinners has stripped the SGP of its teeth.[8]

Taken together, both arguments suggest that the EMF might not be sufficiently strong to enforce the required fiscal discipline which its proponents (and the German government) intend it to do. Thus, with the availability of a rescue fund which lacks credible enforcement tools, the problem of moral hazard might become even more severe than without an EMF.

The EMF might even turn into a threat for European integration. Fiscally sound northern European countries –particularly Germany – would fear being indirectly forced (and to some extent blackmailed, because of the contagious effects of a default) to bail out fiscally profligate EMU countries. At first glance, this fear seems to be mitigated by the fact that the EMF should be partly financed by countries with excess debts and deficits. But northern European countries would have to participate in the initial fund-

5 In fact, many proposals have already been tabled, among them strengthening the SGP, interfering with the sovereignty of a country in crisis, a bailout with *ex post* conditions or based on *ex ante* conditions; see e.g. The Economist: Default lines, No. 49, 5 December 2009, pp. 73-74; Simon Johnson: The Choice: Save Europe Now Or Later, VoxEU, 28 Februar 2009, http://www.voxeu.org/index.php?q=node/3120 [2009-12-23]; SVR, Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung: Die Zukunft nicht aufs Spiel setzen, Jahresgutachten 2009/2010, Wiesbaden 2009. However, all these suggestions, which rely on the eurozone solving its problems internally, will eventually suffer from the same time-inconsistency problems as the no-bailout clause and the sanction threat of the SGP.

6 See e.g. Daniela Schwarzer, Sebastian Dullien: How should the Eurozone handle Greece, 1 March 2010, posted on Eurointelligence, http://www.eurointelligence.com/article.581+M539752bc904.0.html; Charles Wyplosz: The Eurozone debt crisis: Facts and myths, 9 February 2010, Column in Vox EU; Berthold Busch, Manfred Jaeger-Ambrozewicz, Juergen Matthes: Wirtschaftskrise und Staatsinsolvenz, Drohen auch den Industrieländern Staatsbankrotte?, IW-Analysen, Cologne 2010, forthcoming.

7 Thomas Mayer: The case for a European Monetary Fund, in: Intereconomics, Vol. 44, No. 3, 2009, pp. 138-141; Daniel Gros, Thomas Mayer: How to deal with sovereign default in Europe: Towards a Euro(pean) Monetary Fund, CEPS Policy Brief, No. 202, Brussels 2010.

8 One could try to make the EMF as politically independent as the ECB, but such a move would imply surrendering a much higher degree of sovereignty than in the case of monetary policy. The required unanimous support among EMU countries for such a move appears unobtainable. The same line of argument can be extended to the proposed financing mechanism of the EMF which – apart from taking out loans – would be financed by the "sinners", i.e. the countries with excess debts and deficits. Again it is hard to see sufficient political support among EMU countries for this suggestion.

ing and would eventually be liable for the loans which the EMF most likely would have to take out in large amounts in order to obtain sufficient resources for crisis resolutions. Thus, because northern European countries would feel exploited, voters in these parts of the eurozone might turn against EMU. In the end, it is imaginable that northern European countries could even leave the eurozone – in order to form a new currency union.[9]

In addition, there are severe legal and technical obstacles which speak against the creation of an EMF. Most likely, the EMF would violate the no-bailout clause, so that a revision of the EU Treaty would be required – which could easily take several years to materialise. Moreover, it appears excessively costly to build up a competing – and thus possibly redundant – institution to the IMF, because a costly new bureaucracy and immense finances would be needed.

The EMF would not be redundant if – and this leads to a very reasonable aspect of the proposal by Gros and Mayer – the suggested mechanism for an orderly sovereign default was implemented. In order to avoid severe disruptions in financial markets, the EMF would buy Greek government bonds at a discount. This would limit losses for the debt holders and probably save most European banks from sliding into another crisis. At the same time the moral hazard on the side of the creditors would be limited, as they would be prevented from pocketing high interest payments on Greek treasuries without facing a real default risk because they expected a generous financial rescue package by EMU countries.

However, the financial means required to buy a large amount of Greek government debt (which amounts to around €300 billion in total) are immense. The funding of the EMF would have to be even larger, if additional and potentially also larger countries like Spain or Italy were to be rescued. Thus, while the idea of an orderly default procedure is well worth pondering, it appears highly questionable that an EMF could shoulder this task. A better alternative would be to introduce such a mechanism in the IMF.

Arguments for Letting the IMF into the Eurozone

This leads to the main proposal of this article, which has in the meantime been taken up by EMU leaders in principal: to involve the IMF in the case of imminent defaults of EMU countries. Due to the above-mentioned problems with time-inconsistency and with the lack of credibility of the conditionality imposed by EMU countries, an external solution appears more appropriate. The IMF, in particular, is in an appropriate position to take on this task. This applies to the short-term outlook with regard to Greece, but a longer-term institutional reform of the SGP procedures also appears reasonable. EMU countries should be formally required to rely on the IMF in case of imminent default.

The basic idea of involving the IMF was initially put forward by the Cologne Institute for Economic Research as early as March 2009 and has since been elaborated.[10] According to this plan, the IMF should – if necessary – take the lead in a rescue programme for Greece and, most importantly, impose its conditionality. The support package would be co-financed by EMU countries so that there would be a foundation for behind-the-scene cooperation between the IMF and the Eurogroup, but the IMF would have to be ultimately responsible for enforcing its conditionality.

This proposal can be supported by several arguments:[11]

- The IMF is well specialised in crisis resolution and fiscal stabilisation.
- There would be no lack of credibility because the IMF is required by its statutes to impose and enforce reform conditions (conditionality).
- The Fund is used to playing, and institutionally strong enough to play, the role of an external scapegoat. Moreover, it would probably be easier for the Greek government to sell to the electorate and to the trade unions reforms which are imposed from "Washington" rather than from "Brussels" or "Berlin".

9 As an additional caveat the argument can be raised that the EMF might be (mis-)used as a first step towards a political union in fiscal policy issues.

10 Michael Huether: Die Europäische Währungsunion in der Zerreißprobe: Wirtschaftspolitische Empfehlungen, Press Conference, 9 March 2009, Berlin, http://www.iwkoeln.de/Portals/0/pdf/pressemappe/2009/pma_090309_waehrungsunion_statement.pdf; for a current and broader analysis see Juergen Matthes: Why the IMF should be involved in solving imminent fiscal debt crises in Eurozone countries, 27 February 2010, Vox EU, http://www.voxeu.org/index.php?q=node/4683; for an in depth analysis of the sovereign default risks in industrialised countries and for laying out the case for an IMF intervention in the Eurozone in detail see B. Busch, M. Jaeger-Ambrozewicz, J. Matthes, op. cit.

11 On top of all the following points and from the perspective of the IMF, an IMF intervention in Greece could well improve the image of the Fund in the eyes of emerging market economies. In their view, in recent decades it was always the industrialised countries behind the IMF who were imposing adjustment programmes on developing and emerging market countries. Letting the IMF into the eurozone and having the fund impose its conditionality on an industrialised country might thus help the IMF to gain more support among the developing and emerging countries. Such a sound backing is sorely needed if the IMF is to become a more important player in the prevention of global financial crises. The foundation of an EMF, however, would tend to weaken the IMF because the industrialised countries would find it harder to convince Asia and Latin America to rely on the IMF and not to continue to build up regional crisis resolution funds.

- The cooperation between the Eurogroup and the IMF would provide the opportunity for EMU countries to influence the adjustment conditions behind the scenes, as has been successfully tried in the CEE countries Hungary, Romania and Latvia.

- In this case, it could be questioned whether the attempt to divert the blame from EMU countries would be successful. But eventually, this is a question of political marketing and window dressing. A possible strategy could be to have the IMF announce very strict reform requirements and to have the Eurogroup publicly try to mitigate such a harsh approach. Thus, EMU countries – and possibly also Germany – might even be able to position themselves as advocates of the Greek people.

- On top of this, the co-financing of an IMF programme can even promote European integration, because EMU countries would play a constructive role in helping Greece.

- The IMF, in contrast to an EMF, does not need to establish (but already has) an experienced staff and bureaucracy. And, more importantly, the Fund has the required financial resources to support Greece and potentially other, larger European countries as well.

- The threat of an eventual intervention by the IMF with a strict adjustment regime will reduce the moral hazard problem in fiscal affairs. Thus, this institutional innovation could substitute for the no-bailout clause and preserve its spirit. Moreover, it is likely that the fear of the IMF can effectively strengthen the SGP, which is still indispensable as a framework for fiscal surveillance.

- Involving the IMF would amount to an international burden-sharing. In contrast, a European solution would pile the financing and default risk exclusively on eurozone members which are already at (or above) their sustainable debt limits.

- An IMF support package for Greece would most likely carry a lower interest rate than a loan from EMU countries (or from the EMF), because taxpayers in northern European countries would have to be calmed by a significant interest rate penalty. The lower interest rate of an IMF programme would lessen the adjustment burden to some degree.[12] At the same time, the danger of moral hazard due to a relatively low interest rate would be contained by the strict conditionality of the IMF programme.

12 Moreover, it can be expected that interest rates decline as foreign investors usually draw confidence from the IMF intervention.

Qualification of Arguments Against Involvement of the IMF

Calling the IMF into the eurozone is considered by many to be a sign of severe political weakness of EMU. To a certain degree this is surely true. However, the degree of the humiliation (which can be related to the long-standing criticism of EMU particularly from the USA) should not be overestimated.[13] In fact, politicians of EMU countries should be more self-confident, because the first ten years of the euro were rather successful, particularly in terms of price stability and the high credibility of the ECB.

Many arguments continue to speak in favour of EMU – but the legacy of history in Europe and the resulting political fragility of EU integration threaten to prevent the discipline in fiscal and wage policy which is required to make EMU work. If this peculiarity is accepted, then why should a reasonable project like EMU not rely on an experienced external agent to obtain a credible institutional framework which prevents fiscal crises as well as continuing divergences in international competitiveness? Many developing countries also anchor and lock in their reforms by means of external agents such as the WTO or bilateral trade agreements with industrialised countries.[14]

To put it in different terms: the slight damage to the eurozone's image by involving the IMF appears much less grave than the dangers to European integration which would arise if EMU tried to sort out the problems on its own. Politicians have to choose between these alternatives, and on March 25, they did, sacrificing their pride and accepting the obvious political realities – that it appears reasonable to formally involve the IMF in the resolution of potential fiscal crises in EMU countries.

However, a seemingly strong argument against the IMF is raised by some economists and high-ranking politicians. They fear that the IMF – under the alleged strong influence of the USA – could impose weaker conditions on Greece than the SGP procedures require – among other things because the USA has military bases in Greece.[15] While arguing about the reform conditions of a potential future

13 It is true that sharing a currency as a member of EMU is more than simply being an EU member. But one might still wonder why hardly any critical voices were heard when the IMF intervened to help Hungary, Latvia, and Romania. The same argument could have been raised, namely that the EU should have been able to deal with member countries' problems on its own. But this was not the case.

14 In these cases, governance weaknesses in developing countries are the reasons for this strategy. In EMU, the governance deficits do not result from weak governments *per se*, but from the fact that intrusions in the sovereignty of other EMU countries is viewed as politically too sensitive – due to Europe's historical background.

15 E.g. D. Gros, T. Mayer, op cit.

support programme has to remain speculative, some arguments can be raised against this view.

First, it is surely true that IMF conditions have been less strict in recent IMF programmes.[16] This is a reaction to strong criticism for overly strict adjustment burdens imposed by the Fund in the past. Taking the formerly mentioned IMF programmes in CEE countries and the slow but relatively sound economic recovery of these countries as a guide, reform conditions appear appropriate. And that is what ultimately counts.

Second, in the EU-IMF cooperation in CEE programmes, the IMF has adapted to the reform agenda of the Europeans, e.g. in letting Latvia keep its currency peg. This will, thirdly, most likely also be the case with Greece, because the IMF appears highly interested in entering the eurozone, as informed expert circles suggest. If this is true, the IMF will have a strong incentive not to spoil the relationship with the Eurogroup. Fourth, other informed observers appear to be of the opinion that the IMF would probably impose strict reform conditions.[17]

Fifth, it is questionable whether the USA would push for lenient reform conditions for geopolitical reasons. At least this was not the case during the Asian crisis, when southeast Asian countries with US military bases, such as South Korea and Thailand, had to bear rather strict adjustment burdens imposed by IMF programmes. Sixth, the influence of the USA compared to EMU countries in the IMF should not be overestimated. Certainly, it is true that the USA – with a voting share in the IMF Board of Governors of nearly 17 per cent – has a veto in important IMF decisions and considerable influence in the Washington-based Fund. But a Frenchman – with alleged ambitions to return to a prominent political position in his home country – is at the helm of the Fund, and EMU countries have a voting power of nearly 23 per cent – which rises to 32 per cent if the votes of other EU countries are added. Thus, it does not appear appropriate to suggest that EMU would be at the mercy of the USA if decisions on Greece were taken in the IMF.[18]

Several additional arguments that have been put forward against involving the IMF in the eurozone can also be qualified:

- It has been suggested that the IMF – despite paying out its support packages in tranches – lacks instruments to exert sufficient pressure on crisis countries and that an EMF would have additional tools in the form of suspending EU structural fund payments or voting rights in the Eurogroup.[19] However, the threat that a tranche will not be paid out due to lack of reforms is very strong, as this negative IMF sanction tends to let foreign investors withdraw from the crisis country, ultimately leading to a default. Additional sanctions do not appear to be required. In other words, when you can wield a sharp sword, having another two swords is nice, but not necessary.[20]

- It is sometimes said that the IMF can only help a country with a currency of its own. However, the Fund has already provided financial assistance for countries in other currency unions.[21] Moreover, the IMF purposes[22] clearly pertain to providing assistance in case of severe adjustment needs in the *balance of payments* of member countries. It is true that Greece does not have problems with a weak currency and is not in need of an injection of foreign reserves. But even as a eurozone member, Greece is in danger of a current account crisis and should therefore be entitled to the support of the IMF.

- Some observers see the problem that the IMF's usual conditions concerning monetary policy could interfere with the ECB's independence. Yet, in the case of Greece, monetary policy prescriptions appear to be dispensable, as the ECB follows an anti-inflationary policy anyway and the adjustment needs in Greece dampen domestic demand and thus also inflationary pressures. Moreover, there is no need to stabilise an independent currency by raising interest rates. In fact, the IMF has abstained from imposing monetary policy conditions in

16 IMF Conditionality, IMF Factsheet, September 15, 2009, http://www.imf.org/external/np/exr/facts/conditio.htm.

17 The Economist: Now comes the pain, 4 March 2010, http://www.economist.com/world/europe/displaystory.cfm?story_id=15603267 suggests : "The IMF would probably tell Greece to sack thousands of public-sector workers and cut pensions sharply."

18 This also qualifies the general resentment in political circles in EMU countries toward giving the USA a say in the eurozone.

19 E.g. D. Gros, T. Mayer, op cit.

20 This is also true when a country completely refuses to co-operate, because in this case additional sanctions are likewise unlikely to induce reforms. A problem arises when the default of a crisis country would lead to severe contagion to other countries or to the financial sector, which theoretically opens the way for a blackmailing strategy. However, in view of such severe non-cooperation, it is improbable that additional sanctions by the EMF would help. In this case the above-mentioned orderly sovereign default mechanism as proposed by D. Gros and T. Mayer is required.

21 Sean Hagen: 10 Years of the Euro: A Perspective from the IMF, speech held at the ECB, 29 January 2009, http://www.imf.org/external/np/speeches/2009/012909.htm, [2010-01-04].

22 Article I (V) of the IMF's Articles of Agreement states as a purpose of the IMF: "To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity *to correct maladjustments in their balance of payments* without resorting to measures destructive of national or international prosperity (italics added), http://www.imf.org/external/pubs/ft/aa/aa01.htm.

the Fund's dealings with other currency unions. Furthermore, required reforms in Greece concern other policy areas such as, mainly, fiscal policy, but also wage policy and deregulation issues. Higher than EMU-average inflation in Greece could be targeted by limiting wage increases, which usually are the most important price drivers.

- EU treaties – it is said – would not allow the IMF to bail out an EMU country because the Fund uses funds from the central banks of EMU countries. However, this use is only indirect and – in contrast to the forbidden direct financing of government expenses by an EMU central bank – the IMF's financial assistance is conditioned on reforms. In addition, the part of the IMF's finances originating from EMU central banks is limited and would also stem from central banks outside EMU.

- Some suggest that the performance of IMF programmes in countries with fixed exchange rate systems (like Argentina) was rather disappointing. It is true that the absence of the possibility of devaluing the currency of a crisis country makes the adjustment process harder and thus the risk of failure greater. But EMU countries (or the EMF) would be even more likely to fail, because they lack the experience of the IMF.

Conclusion and Outlook

All in all, the arguments overwhelmingly speak in favour of involving the IMF in the case of an imminent default by an EMU country. Using the threat of an IMF intervention could eventually strengthen EMU's institutional framework to discipline decentralised decision-making in fiscal policy.[23] This is a better and – above all – more realistic alternative than an EMF or even a political union, which is very much resented because it entails strongly interfering in the national sovereignty of EMU countries.

23 It also appears necessary to introduce certain disciplines on wage policy in order to avoid recurrent divergences in international competitiveness among EMU countries. To achieve this, the Cologne Institute for Economic Research has proposed a European Stability Commitment in March 2009 (M. Huether, op. cit.). Again, the threat of an IMF intervention in the case of a current account crisis (which would result from ever decreasing competitiveness) should provide strong incentives not to let wages continually increase in excess of productivity growth.

Deborah Mabbett and Waltraud Schelkle

Beyond the Crisis – The Greek Conundrum and EMU Reform

"Never waste a good crisis" is an old political maxim, but it has recently proved difficult for politicians to seize the initiative in economic policy. Stresses in financial markets have reduced the policy-making space available to governments and forced political leaders to follow events rather than leading the way. It is particularly galling for governments, having rescued the financial sector, to have it turn the tables and set the terms of fiscal responsibility. While opinions are sharply divided among European politicians about the best way to respond to the Greek crisis, on one point they are united: fiscal policies should not be dictated by the financial markets. This is a basis for a political consensus on why something needs to be done.

It is of vital interest to all member states that a country's public finances are not exposed to attacks for the wrong reason. Paul De Grauwe asked the right question early on, when bond spreads started to rise: "Why should we believe the market this time?"[1] Interest rates were on the decline and safe private investments hard to find, so there was little reason to get choosy about some government bonds in the euro area but not others. But even if a country is attacked for the right reason, the timing and the consequences may be wrong. The manipulation of budget data and the shady swaps executed with the help of Goldman Sachs can be seen as evidence of the depth of Greece's fiscal problems. But forcing the besieged state to fiscal contraction makes it so much harder, if not impossible, to get back on a sustainable path. This is why, for firms that are still "going concerns", we need insolvency rather than bankruptcy procedures. For EMU as a whole it is crucial to prevent a succession of Greeces, or even Irelands, given that an accumulation of Irish-style austerity packages would eventually add up to a significant macroeconomic reversal, even if it is the smaller countries on the periphery that are picked off first.

Greece has fundamental fiscal (and economic) problems that it needs to sort out. But this holds, to varying degrees, for most EMU member states. And this is no coincidence: the interest in joining the monetary union was borne by the hope that it would be easier to tackle these problems with lower interest rates and less disruption from foreign currency markets. So the question for EMU is how this hope can be kept alive.

To anticipate our conclusion: public finances in EMU must be reorganised to utilise the strength of the euro area and not allow individual states to be picked off. To avoid procyclical fiscal responses, the EU needs a financing mechanism that helps to tide countries over a recession. The first tier of this mechanism would be a Eurobond with a common interest rate that would provide financing for deficits approved within the fiscal framework. Determining the quota for lending overall and from this facility could be a way for the Eurogroup to coordinate fiscal policies and reward compliance. For the second tier, for countries with excessive deficits, we are not convinced that a European Monetary Fund (EMF) is economically necessary and politically opportune. A stabilisation facility with the European Investment Bank (EIB) would do, as others have pointed out. But the facility could emulate the IMF in making funds conditional on plans for fiscal adjustment.

As with the IMF, countries will only turn to this facility if private financing alternatives have become too unstable and expensive. Here, the role of credit rating agencies invites reform. These agencies have been empowered by embedding their ratings in regulatory frameworks. This has happened because there is no way for a national public agency to emulate their function. But equally, the extent of reliance on ratings now built into monetary policy and banking regulation is untenable. Public providers of the data that sovereign ratings rely on, such as Eurostat, could extend their provision of indicators to render some uses of ratings redundant. Regulators could classify financial instruments into classes and adopt statistical indicators of their riskiness rather than hiding behind the ratings agencies. By such means, regulators would acquire more capacity to give countercyclical signals, and this would strengthen the coordination of monetary and fiscal policy in the eurozone.

The Problem with the Status Quo

The Greek crisis highlights the cyclical asymmetry of fiscal discipline. In the depths of recession, the state of Greek public finances has finally aroused concern in the markets. Statistical information released by Eurostat is closely watched. The Greek government has taken unpopular steps in a bid to obtain a favourable verdict on its fiscal programme from the European Commission and the rating agencies, as a first step to regaining market confidence. Suddenly, the procedures established under the Stability and Growth Pact (SGP) have the weight of the markets behind them.

How times change. The European Commission repeatedly called attention to the weakness of Greece's position before the downturn struck. As early as 2002, Eurostat raised issues about the fiscal statistics and determined that Greece's deficit was larger than had been thought. In 2004, the Commission launched an Excessive Deficit Procedure (EDP). The deficit was only just over the 3% threshold, but it was the right time for restraint, as the Greek economy was booming. Even though statistical problems were still being uncovered and fiscal policy processes were clearly weak, the markets were unperturbed. It became clear that there was only a small interest rate penalty for fiscal laxity in good times. The Commission found itself a lone voice in the general climate of easy optimism.

One challenge, then, is to tackle the long-standing problem of how European institutions for economic policy coordination can be made to matter in good times as well as bad. What incentives could have produced more Greek restraint in 2003-06, thereby reducing the severity of procyclical cutbacks in 2009-10? It seems that the "good housewife" norm of budgetary policy – that one must always live within one's means, so one can afford more in good times and less in bad times – makes too much common sense. Hence, governments need to have incentives that strengthen their countercyclical resolve vis-à-vis spending ministries, domestic constituencies and the temptations of bond markets. This challenge is part of the larger problem of achieving fiscal policy coordination in the eurozone.

The other challenge is to address the immediate problem of debt crises in overexposed countries. The crisis of 2007-09 has wiped out twenty years of fiscal consolidation and left a legacy of budgetary calamities for years to come. Therefore, EMU needs rules and facilities for the eventuality of bailouts that are bound to arise.[2] Thus it is now widely agreed that there is a need for a stabilisation fund on which governments can draw in an emergency. This is the plausible and pragmatic argument behind the proposal for an EMF.[3] At the time of writing, EMU members had not made up their minds, however, whether

1 P. De Grauwe: Why should we believe the market this time?, ECMI Commentary No.22, 20 February 2009, European Capital Markets Institute [URL: http://www.eurocapitalmarkets.org/taxonomy/term/7; accessed 19 March 2010].

2 L. Bini-Smaghi: It is better to have explicit rules for bail-outs, in: Financial Times 16 March 2010, p.11.

3 T. Mayer: The Case for a European Monetary Fund, in: Intereconomics, Vol.44, No. 3, 2009, pp.138-141.

members in crisis should take recourse to the IMF or have a European facility to turn to.[4]

The Eurobond as a Vehicle for Policy Coordination

We address the longer-term challenge of countercyclical policy first. The creation of a common financing facility, a Eurobond, could be an entry point for closer fiscal coordination in normal times and create incentives for countercyclical policy in good times. This Eurobond proposal therefore differs from that proposed by De Grauwe and Moesen[5] to deal with financial emergencies, of which more below. Access to the Eurobond would be governed by compliance with the European fiscal framework. Member states would have to agree annually – or more frequently if economic circumstances so require – on the overall volume of bonds to be issued and the share of each member state. This would determine, within reasonable margins of error, the appropriate fiscal stance for EMU as a whole, based on the projected cyclical phase for the euro area. By determining the quota and thus the contribution of each country to the overall stance, the facility could take account of the fact that we still have asynchronous business and asset market cycles in the monetary union. The bond issue would be guaranteed collectively by the member states, and all would pay the same interest rate. Given that the Eurobond should not have any country names attached to it, a suitable issuer would be the EIB rather than national treasuries.

For many eurozone countries, a Eurobond could set a valuable ceiling to spreads, even though it is possible that Germany or the Netherlands could always obtain financing more cheaply. The Eurobond conditions would send a signal to markets that could raise spreads for countries which had used up their access rights, so that borrowing to finance an excessive deficit might begin systematically to carry an interest rate penalty. The Eurobond is not a magic bullet: excessive deficit countries might still be able to borrow cheaply in booms, and the value of the insurance of Eurobond access might be discounted in good times. However, member states who do this may find their share in the Eurobond allocation reduced in the next period; in other words the variable national quotas can be used to sanction those who do not stay within the agreement. The Eurobond would thus represent a start in giving EMU's fiscal framework some pecuniary substance in contrast to the current oversupply of blaming and shaming.

Furthermore, the Eurobond could begin to provide the basis for addressing the problem of fiscal policy coordination to tackle imbalances within the eurozone. So long as fiscal policies are monitored country-by-country, and so long as excessive deficits but not excessive demand restraint can be penalised, the fiscal stance of the euro area will have a bias towards rectitude, dampening the union's economic dynamic. This would not matter so much if there were not large current account divergences, whereby some countries export their way out of low domestic demand. One-sided adjustment of the deficit countries is not in the interest of these surplus countries, as it would depress their export markets. Yet acting on this insight is a serious collective action problem. Coordination over the size and allocation of Eurobond issues could ultimately provide a route to resolving this. It remains the most intractable problem of the eurozone, however.

A Stabilisation Facility for Crisis Management

De Grauwe and Moesen[6] proposed a Eurobond to give countries like Greece guaranteed access to funding, albeit at the national market interest rate. Compliance with the fiscal framework would not be a condition of access. Instead, each country would pay its market rate, which would penalise the profligate (assuming they were accurately identified by the markets) and address German resistance to a common interest rate for countries that had breached the SGP. At the same time, the bond issue would be guaranteed by all the subscribing countries, and the coupon that bondholders receive would be calculated as the average of the market interest rates that the participating countries paid. This seemed to be an ingenious way to combat the "flight to safety" which threatened to deprive the Greek government of liquidity.

But times have moved on, and Greece is now (in mid-March 2010) complaining that spreads on its bonds are excessive given the steps to fiscal correction that have been taken. Just as the 2004 EDP failed to produce a market signal to penalise Greek profligacy, so the latest measures have failed to persuade the markets that lower spreads are justified. The stark outcome is that Greece can now credibly threaten to call in the IMF, knowing that an IMF stabilisation programme would not be more draconian than existing measures, and that Greece would

4 The Financial Times reported that Finland, the Netherlands and Italy prefer Greece to use the IMF, while France and Spain strongly favour treating this as "an internal matter for Europe's monetary union"; see "Eurozone unity cracks on IMF aid for Greece", Financial Times, 18 March 2010, p 1. The German government was divided over the issue and finance minister Schauble possibly not sincere with his EMF proposal; see W. Schelkle: Wolfgang Schäuble's Proposal for an EMF: Belated Insight or Smokescreen?, in: AICGS Advisor, 18 March 2010 [URL: http://www.aicgs.org/analysis/c/schelkle031810.aspx].

5 P. De Grauwe, W. Moesen: Gains for All: A Proposal for a Common Euro Bond, in: Intereconomics, Vol. 44, No. 3, 2009, pp.132-135.

6 P. De Grauwe, W. Moesen, op. cit.

then obtain access to funds considerably below the current market rate. The challenge to the European institutions is clear: can they provide access to emergency lending on similar terms? Perhaps the answer is no, and the IMF will come in. But there is a good reason to look for an alternative, as it could provide a further opportunity to strengthen fiscal monitoring and incentives for fiscal compliance in the euro area.

Neither our proposal for a Eurobond with a common interest rate nor De Grauwe and Moesen's scheme for providing emergency liquidity are substitutes for the IMF. Another mechanism is needed to provide access to additional funds at a penalty rate, comparable to that of an IMF facility, and available only when a stabilisation programme is agreed to. We think that a facility at the EIB would serve the purpose. It could be set up relatively quickly and as an institution on demand, not as a permanent agency with its own mission and the inevitable mission creep. Two factors complicate the development of this facility. One is the "no bailout" objection, which means that a deal between European ministers might be subject to a legal challenge, particularly in Germany. The other is the political process of negotiating a stabilisation programme. The IMF is accustomed to playing the role of unpopular outsider, imposing technocratic solutions against the will of democratically-elected governments, whereas EMU is too much of a political union to have the Council and the Commission impose IMF-style conditionality on a member – thus the attraction of delegating the task to an outside agency like the IMF or a new EMF.

Advocates of an EMF see it as solving both bailout and policy supervision problems. We see the "no bailout" objection as surmountable with existing institutions. Article 125(1) in the Lisbon Treaty prohibits a bailout in the sense that no member state shall be liable for the debt of another member state. But Article 122(2) allows for the grant of "Community financial assistance" to euro area members "with severe difficulties caused by natural disasters or exceptional occurrences beyond its control", while Article 143 allows for "mutual assistance" to non-EMU members with balance of payments difficulties.[7] In other words, the much heralded no-bailout clause of EMU is only there to ensure that fiscal surveillance does not create expectations of mutual assistance. The rationale for this preventive measure is of course to avoid moral hazard. But once prevention fails and the emergency situation arises, one can use Articles 122(2) and 143 to justify a bailout to avert a spreading of the crisis.

7 We are grateful to Susanne Mundschenk who has alerted readers of the news service www.eurointelligence.com to these clauses in the Consolidated Treaty, on 18 February 2009.

The greater difficulty arises in the procedures for approval of stabilisation plans. Mayer proposes that an EMF, like the IMF, would undertake professional surveillance of fiscal policies and would give financial support only under strict policy conditionality. Like us, he would like to see more fiscal policy capacity at the EU level, suggesting that "an EMF should over time develop into an institution allowing a better coordination of fiscal policy among EMU member countries and between fiscal and monetary policy in EMU. Moreover, it could manage the issuance of a common euro government bond in the future."[8] But it is not clear why the staff of the EMF would have more political independence than the staff of DG EcFin who currently conduct fiscal surveillance under the SGP, in which case the Commission may as well do the job. The funding authorised and disposed of by an EMF or the EIB will have to be underwritten by the member states; no institutional smoke and mirrors can conceal that political agreement will be needed for any emergency assistance to be given.

Politics, Markets and Delegation

The fundamental problem for fiscal policy is how to create incentives for countercyclical policy in the face of procyclical markets. This problem is a deep challenge to schemes for delegation of macroeconomic policy-making to autonomous non-political institutions, as their influence depends on the responses of their financial market "audience". The markets failed to punish Greece in the upturn; now they persecute her to destruction in the downturn. The Commission and Eurostat were ignored by the markets in good times, and now they are unable to reassure the markets in bad times. Thus our central argument is that the authority of the fiscal framework has to come from the disposition of control over funds: access to a common Eurobond for compliant countries and to emergency funding on IMF terms for the others.

However, as we indicated above, even these arrangements are likely to be cyclically asymmetric, with no effective sanctions to fiscal profligacy in good times. Access to the Eurobond will not have much leverage if spreads are small. The pronounced cyclicality of spreads in the eurozone has drawn attention to the role of the rating agencies. Until the crisis, they gave all eurozone members similar ratings; now, the range of ratings has widened and so have spreads. The cyclicality of ratings worsens the cycle, because it raises costs when borrowers are at their most stressed. The policy effects on governments are profound, since borrowing costs are a key determinant of the fiscal position. The rating agencies can potentially make self-fulfilling prophecies, pushing costs up if they assess

8 T. Mayer, op. cit.

the policy effort as inadequate and thereby ensuring that further retrenchment will be needed.

The rating agencies' own accounts of their policies emphasise that ratings should not be cyclical. They seek to establish long-term ratings for sovereign borrowers based on structural factors such as legal institutions and political stability, but they have difficulty withstanding cyclical pressures to downgrade borrowers. One explanation is that they cannot undertake a macroeconomic analysis but must view each borrower as if its policies will not affect the outcome for the system as a whole. Of course this is justified for the purpose of rating, even if it is perverse for system demand management, but it produces a distinctly anti-Keynesian bias in country policy assessments. The agencies also have their own "herd" tendencies, often making their announcements on the same days and preserving their reputations by ensuring that their ratings do not deviate too much. For example, Moody's initially rejected moves to downgrade Greece, telling investors on 2 Dec 2009 that "investor fears of a liquidity crisis in Greece are overdone", but on 22 Dec it followed the others in lowering its rating, albeit remaining two notches higher than its rivals.

Why do ratings matter so much in Europe at the moment? With no financial resources of their own, European fiscal authorities are particularly susceptible to the mood of the financial markets. At present, the European Commission is producing fiscal policy assessments which are almost identical to those of the rating agencies. All use the same phrases: assessing whether the government's plans are adequate to meet its fiscal targets, noting that official growth forecasts are probably overoptimistic, and questioning policy-makers' ability to respond to future budgetary challenges, with a particular emphasis on pension liabilities and social security reforms. One could say that the agencies are finally taking note of the authoritative data and analysis issuing from Brussels, but a less flattering interpretation is that the Commission is trying to establish a reputation with the markets by telling them what they expect to hear. By contrast, the IMF can afford its recent bout of Keynesian delinquency[9], as it has the financial resources to back up its position.

The creation of Eurobonds could go some way to establishing a more independent-minded approach to fiscal policy, less dependent on market approval. But a further problem is that ratings are embedded in the monetary governance of the eurozone. Most strikingly, the ECB's acceptance of a wide range of collateral at its discount window has gone along with passive use of ratings. As Austria's central bank governor, Ewald Nowotny, has argued, it is "unacceptable" that the ECB's acceptance of Greek debt rests on the judgment of the rating agencies.[10] If the Bank envisages the prospect of not accepting euro area sovereign debt, it should spell out its own terms. It could make more active use of margins and fees, to the detriment of SGP non-compliant governments, but it should not hide behind the rating agencies in doing this. By making its own judgments, it could contribute to countercyclical policy-making; by abdicating, it magnifies the procyclicality of rating agencies' judgments.

Other regulatory policies could also be disentangled from reliance on ratings. Instead of using ratings to determine capital requirements, banking regulations could return to the pre-Basel II practice of differentiating between classes of debt on other criteria. The new Eurobond would belong to the most privileged class of debt, while country issues could be graded according to debt ratios and trends. Such changes could be part of making more active use of capital ratios as a countercyclical instrument. Through regulatory means, the market signals that failed to materialise in the early years of the euro could be engineered.

Concluding Remarks

The difficulty of achieving political agreements in the eurozone has contributed to the creation of a fiscal framework that lacks fiscal instruments and a monetary policy framework that is detached from fiscal monitoring. But the effect is an abdication of power that leaves too much to be dictated by the financial markets, as politicians from Greece to Germany are now realising. Delegation to the market may look like a way of avoiding political conflict, but it also reduces the policy-making space available to governments. This did not bother economists in the era when governments were seen as the primary cause of macroeconomic instability, but it is a huge problem when financial markets themselves are the cause. The financial sector has been allowed to set the terms of fiscal responsibility because the alternative might be that Germany sets the terms for Greece. But Europe is surely by now a sufficiently wide and deep polity that such costly political abdication can be replaced by more robust regulation by the fiscal and monetary authorities. It is time for the public face of international finance to be seen a little more clearly.

9 O. Blanchard, G. Dell'Ariccia, P. Mauro: Rethinking Macroeconomic Policy, IMF Staff Position Note SPN/10/03, 12 February 2010.

10 Quoted in "Bank signals break from rating agencies", Financial Times, 18 March 2010, p. 27, where the Bank of England's proposals partially to delink its discount policy from credit ratings are also discussed.

Wim Kösters*

Challenges Facing European Monetary Union – Rules and Assignment or Discretion and Coordination?

As is well known, classical Greek tragedies are about insoluble conflicts. They are intended to deeply touch spectators, make them think about it all and eventually come to a purification of their minds (Greek: catharsis). The present crisis of the European Monetary Union (EMU) emphatically reveals many problems, some of which have to do with Greece, and hopefully all of which can be resolved. It might, however, be a good idea to follow the ancient tradition and let the discussion of the problem clear our minds to gain deeper insights into the problem.

The Present Situation

Media reports often give the impression that the worldwide financial and economic crisis caused the fiscal problems of certain EMU countries which were quickly termed PIIGS (Portugal, Ireland, Italy, Greece and Spain). Dramatically increasing public deficits and debts made investors hesitant to give new loans because they feared a state bankruptcy, especially in the case of Greece. Rising interest rates and premiums for loan default insurance are indicators of those fears. For several days at the end of January 2010, the interest rate on Greece's government bonds was nearly 400 basis points above that of Germany's. In addition, the prices of credit default swaps (CDS) have increased dramatically in recent months. The government bonds of the countries in question (again primarily Greece) are being watched by the markets with great anticipation.

In response to this situation, politicians and others quickly demanded that speculation be brought to an end and that Greece ought to receive financial assistance, either bilaterally or from the EU. Otherwise the EMU could break apart, and the present crisis could be aggravated because German, French and other banks holding a good deal of Greece's public debt would encounter significant difficulties. Therefore, it would be in the interest of the other EMU members to help Greece.

The main challenge seen by the proponents of assistance is choosing the most appropriate instrument. Currently, issuing common euro bonds, creating a European Monetary Fund (EMF) and introducing an economic government for EMU are under discussion, in addition to direct transfers from the EU or bilaterally. Remarkably, most of those proposals were initially made without considering that the Stability and Growth Pact (SGP) and the Maastricht Treaty strictly forbid financial assistance to a member state of the EMU (due to the no-bailout clause of Article 103). In addition, it is clearly stated that the European Central Bank (ECB) is independent, and therefore monetary policy cannot be made subject to coordination within a European economic government. After these critiques were voiced, an additional challenge was seen in finding ways to bypass those rules.

The real challenges presently facing the EMU, however, go beyond just these. Since the problems are more deeply rooted, the challenges are different and much bigger. They pertain to the governance of the EMU, and the question has to be raised whether the EU will be able to manage it or will wreck it. In spite of the European treaties, there is no real agreement on the fundamental principles ruling the EMU that is fully accepted by the member countries. The reason for this is that either the rules agreed upon in the treaties are not fully understood or that they are not wanted and, therefore, not accepted. In any case, questions were raised early and often regarding these rules but never really taken seriously. This is especially true with regard to the public budget rules and the independence of the ECB in striving primarily for price stability. The results of this ambiguity are the present problems facing the EMU and some of its member states in particular. They have not been caused by the worldwide financial and economic crisis per se so much as by the general disrespect for the rules agreed upon in the European treaties. The present crisis merely exposes the failures and omissions of the past.

Rules and Policy Assignment in the European Treaties

In the Maastricht Treaty, the decision was made to create rules and institutions for the EMU which very much resembled the German ones: an independent central bank obliged to give priority to the goal of price stability and an interdiction of the monetary financing of public budget deficits. Thus, monetary policy has clearly been tasked with the goal of maintaining price stability. The ECB is thereby removed from everyday politics and cannot be made responsible for the achievement of other goals, e.g. employment and growth. Furthermore, its independence

* The author wishes to thank Fabian Kösters and Lina Zimmermann for a critical check and most valuable editing.

is safeguarded by the SGP with its well-known budget deficit and debt rules and the no-bailout clause, which clearly states that no government can hope for financial assistance from the EU or other EMU member states if it allows its public budget to drift into an unsustainable position. In case of violations, a formal deficit procedure must be initiated which can result in the imposition of sanctions. All this should guarantee that European monetary policy remains oriented towards price stability.

When seeking assent for the Maastricht Treaty among its fellow citizens, the German government repeatedly assured the public that this arrangement of rules would make the euro as stable as the Deutsche Mark (DM) that it was replacing. This assurance was necessary for the acceptance of the new currency, given that Germans had lost nearly all of their savings twice within one generation due to two big inflations in the last century. As a result, the stable DM had become a symbol for reconstruction after the war. Since the DM was the anchor currency within the European Monetary System, Germany gave up its monetary hegemony when joining the EMU.

In the Maastricht Treaty, the other Europeans accepted the adoption of the German model to a great extent in the design of the new European monetary constitution. At least it appeared that way initially. All parties declared their preference for a stable euro brought about not by currency competition but rather by more or less the adopting of a German model that had proven its ability to achieve a very stable currency. The Delors report recommended this as the best available alternative. If all parties had followed what they had agreed upon in the treaties, the completion of the single market and consolidated public budgets in all member countries would soon have followed. In addition, because of the highly intensified systems competition within the EMU, urgently needed structural reforms would have been carried out and wages and prices would have become more flexible. This would have enhanced the adaptability of the European economies. The present crisis, the problems of aging societies and adjustments to the needs of globalisation could have been coped with much more effectively. The problems of Greece and other countries are, therefore, the result of failures and omissions in the past. The challenge therefore is not to hide them but to avoid repeating them in the future.

Current Policies in Favour of Discretion and Coordination

It must be remembered that when the Maastricht Treaty was agreed upon, Germany and the Netherlands were the only member countries with independent central banks. In some EU countries, the monetary financing of public deficits was allowed and routine. In addition, the economic policy style was different. The acceptance of binding rules for public budgets was mostly unknown. To the French for example, it must have been quite new and perhaps strange that the president of the republic and the parliament would no longer have full command over the public budget and such an important instrument as monetary policy. Therefore, President Mitterand, in the decisive final debate on French television before the referendum, did not dare to tell the truth about the independence of the ECB. He claimed, contrary to the rules of the Maastricht Treaty, that the European Council would make the basic monetary policy decisions, not the ECB, which would only execute them and conduct the daily business.

After the referendum which resulted in the well-known decision in favour of France joining the EMU, intellectuals in France initiated a major debate over the EMU when they realised the true contents of the Maastricht Treaty. This debate is still ongoing. In the last French presidential election campaign, all candidates demanded changes to Europe's monetary constitution in favour of the creation of a *gouvernement économique* and a reorientation of the ECB that placed less emphasis on price stability. It just did not seem acceptable to them for the EMU to be based on binding and sanction-equipped rules. It does not seem to suit the French policy style, which considers policy only to be discretionary action and not rule adherent. The latter style is pejoratively referred to as technocratic, in contrast to political.

Although the rules and obligations in the Maastricht Treaty suit the German policy style much better, even Germany turned away from its original position. The Kohl government still cared very much for the essentials – like independence of the ECB, price stability orientation etc. – when bargaining over the monetary union, and it also pushed through the SGP. The Schröder government, however, under its first Finance Minister Oskar Lafontaine, took a quite different position and no longer took the SGP seriously. The deficit procedure initiated by the European Commission against Germany in 2003 after its violation of the budget deficit criteria was not accepted by Germany. Together with other countries, particularly France, rule changes aiming at a dilution of the pact were pushed through. The now "reformed" SGP prolonged the periods of adjustment and allowed for all kinds of exceptions, watering down the political pressures for public budget discipline that it had originally intended. With this move, Germany – as a "custodian" of the original construction of a stability-oriented EMU – finally lost its credibility and vanished in that respect.

This also happened to the true custodian of the European treaties, the European Commission. It had already lost part of its credibility in the first round of admissions to the EMU in 1998 because its examination of countries' compliance with the convergence criteria was quite lax. Even then countries were allowed to join which were far from fulfilling the standards of the Maastricht Treaty. Italy and Belgium were admitted even though they had debt quotas of nearly double the allowed 60 per cent. But even Germany did not meet all the standards, because its debt quota was slightly above 60 percent and was increasing. As no justification for this can be found in the treaty, Germany should not have been admitted either. This shows that the EMU rules were being twisted from the start. This occurred to a much greater extent during the second round in which Greece was admitted in 2001. The Commission cannot have been very thorough in its examination of the Greek figures since it failed to uncover that the figures had been forged. Indeed, this lack of thoroughness was fairly constant, since it turned out that Greece had not complied with the SGP rules for even a single year since it joined the EMU.

This was only possible because the Maastricht criteria were not taken seriously by the European Commission or by the member states. A typical indication for the former is a comment by the then president of the European Commission, Romano Prodi, in an interview with Le Monde in October 2002 (one year after the admission of Greece!) that the SGP was stupid, like all rigid decisions are. One could ask if he also meant the independence of the ECB, the single market rules or other rules in the European treaties. After such a comment, one could hardly expect that the SGP criteria would be examined thoroughly by the Commission. Perhaps it preferred not knowing exactly what was happening. This is also most likely true for the other member states, since they often found themselves in similarly difficult budget positions. Thus, it appears that, for opportunistic political reasons, nobody really took responsibility for ensuring adherence to EMU rules.

Preventing the Breakup of the EMU

All actors were eager to widen their scope for discretionary policy action. However, if this tendency is not stopped at once, the EMU could soon break apart. If every member country acts as it pleases and chooses when, and when not, to comply with common rules, then there will no longer be any economic convergence within the EMU. Not only Greece but also additional member states could face bankruptcy. It quite simply would be neither fair nor sustainable for Germany and a few other EMU members to have to foot the bill. How can a government explain to its voters bailouts of other countries that chose not to follow the rules agreed upon in the treaties? Voters would become even wearier of Europe and might ultimately reject European integration in general.

Therefore, what is most urgently needed now is an immediate and substantial turnaround and the credible commitment by the European Council and all EU member states to strictly adhere to the rules with respect to the EMU without any ifs, ands or buts. To begin with, this requires that Greece must not be assisted by the EU or the member states, in keeping with the no-bailout clause. It should instead be referred to the IMF, which is very experienced in cases like this, can set strict conditions in exchange for its loans and is able to ensure that these conditions are met. The EU would thereby admit that it was unable to care for good governance within the EMU and needed the IMF's assistance. This, however, is the plain truth that cannot be hidden from the world. The attempt to do so by assisting Greece against all common agreements in one way or another would cause the EU to lose its credibility. Furthermore, it would make good governance within the EMU much more difficult if not impossible in the future.

Therefore, what appears to be helpful in the short run could do great damage to the EMU in the medium and long terms. This applies to some of the recent proposals. If common Euro bonds were issued to help Greece immediately[1], this could initially calm down speculation and create more favourable conditions for the country to finance its public debt. But the costs of this measure would show up later, because good intentions do not necessarily produce good results.[2] Since the no-bailout clause would be violated, a credibility and moral hazard problem would develop. What incentives will there be for Greece and other member countries to struggle to consolidate their public budgets in the medium to long term? Since Germany and other assisting states would take on more liability, they would have to pay higher interest rates for their debt. The bad governance of the EMU would thus damage the competitiveness of all EMU countries, even those which comply with the rules. This would most probably end in permanent conflicts, making the EMU less and less attractive.

This could also be the case with the French proposal of a *gouvernement économique*. As said before, French politicians disliked the rules of the Maastricht Treaty from the start. The idea of an economic government is intended

1 See e.g. P. De Grauwe and W. Moesen: Gains for All: A Proposal for a Common Euro Bond, in: Intereconomics, Vol. 44, No. 3, 2009.

2 For a critique of Common Euro Bonds see e.g. W. Kösters, Common Euro Bonds – No Appropriate Instrument, in: Intereconomics, Vol. 44, No. 3, 2009.

to weaken or to replace important rules previously agreed upon in the European treaties with discretionary action. Since this is seen as a potential counterpart and counterweight to the ECB, it would endanger its independence. Instead of the clear assignment of pursuing a monetary policy that leads to price stability, it calls for coordination in general. This, however, would only make sense if all policy instruments were made responsible for all economic goals – a definite contradiction of the Maastricht Treaty. A taste of future interventions and quarrels along those lines was delivered in recent remarks by Christine Lagarde, the French Minister of Finance.[3] She proposed that Germany should take steps to become less competitive internationally by increasing its wages and exporting less. Besides the disregard for rules this exhibits, it is also inconsistent with the Lisbon strategy, which aims at making EU countries more competitive internationally. Thus, an economic government could result in permanent conflicts, inconsistencies and bad governance that damage the attractiveness of the EMU and put its sustainability at risk.

This also applies to the proposal of a European Monetary Fund (EMF), which was made with the good intention of forcing countries violating the budget criteria of the SGP to contribute to that fund. In this way, incentives would be set in place for an early and fast consolidation of public budgets. The necessary adjustments within countries in need would be supported by the financial assistance of the EMF but only if the countries had made their required contributions. The conditions for support would be as strict as those of the IMF and controlled by the ECB.[4] Founding the EMF would require a change to the European treaties because the no-bailout clause would have to be abandoned. As former chief economist of the ECB Otmar Issing[5] and others have said, this would be like opening Pandora's box, for one does not know what one would receive in exchange. This point is illustrated by a comment about the EMF in the French newspaper La Tribune.[6] It predicts that the EMF will not be created because the Germans consider it to be a super SGP-enforcing form of discipline, whereas the French consider it to be a blank cheque signed by Mrs. Merkel. Bargaining and ratifying a new treaty takes about ten years, and the result cannot be foreseen. Therefore, it could (and most probably would) end up with conditions for financial assistance much less strict than the authors had in mind. The probability is very high that loans would be provided much more easily than originally intended, either based on a compromised original agreement or – as was shown before – in practice. The danger, therefore, is that the EMU would turn into a transfer union without being a political union. This again would endanger the support of the people for European integration in general and for EMU in particular. It would thus be better not to touch existing rules and to agree instead on a European consolidation pact as proposed by the German Council of Economic Advisors.[7] This would not replace but rather supplement the SGP. It is intended to strengthen budget discipline by seeking binding commitments from all EU countries for a swift consolidation of their public budgets.

At the moment, there are various attempts to change the EMU rules that were agreed upon in the treaties without following the appropriate procedures. This could backfire and lead to worse governance and even the dissolution of the EMU. The big challenge now is to fully accept and maintain the rules that make the EMU sustainable in the long run. Money is a much too serious matter to be left to everyday politics.

3 See e.g. Frankfurter Allgemeine Zeitung, 18 March 2010, p. 1.

4 See D. Gros, T. Mayer: How to deal with sovereign default in Europe: Towards a Euro(pean) Monetary Fund, in: CEPS Policy Brief No. 202, February 2010.

5 See Frankfurter Allgemeine Zeitung, 14 March 2010.

6 See François Lenglet: Quand le Rhin s'élargit, in: La Tribune, 20.03.2010.

7 See Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung: Die Zukunft nicht aufs Spiel setzen, Jahresgutachten 2009/10, Wiesbaden 2009, pp. 79-92.

Paul De Grauwe

The Greek Crisis and the Future of the Eurozone

The crisis that started in Greece culminated into a crisis of the eurozone as a whole. There is no doubt that the major responsibility rests with the Greek authorities who mismanaged their economy and deceived everybody about the true nature of their budgetary problems. The solution to the problem will therefore necessitate drastic changes in Greek economic and budgetary policies. That being said, there is more than one villain in this story. The financial markets and the eurozone authorities also bear part of the responsibility for letting this crisis degenerate into a systemic crisis of the eurozone.

The destabilising role of financial markets has been dramatically illustrated again. Periods of euphoria alternate with periods of depression, amplifying movements in asset prices that are unrelated to underlying fundamentals. This is not new, of course, but the speed with which this has occurred is baffling. Just a year ago the sovereign bond markets were gripped by a bubble leading to record low levels of long-term interest rates at a time when governments added unprecedented amounts of new bonds to the market. In a few weeks time the situation turned around dramatically and bond markets in a number of countries crashed. It is a repeat of a sad story: financial markets are first blinded and see no risks until the wake-up call comes, at which point they overreact, making the resolution of the problem more difficult.

The rating agencies take a central position in the destabilising role of the financial markets. One thing that is clear about these agencies is that they systematically fail to foresee approaching crises. And after the crisis erupts, they systematically overreact, thereby intensifying it. This was the case two years ago when the rating agencies were caught completely off guard by the credit crisis. It was again the case during the last few months. The sovereign debt crisis started in Dubai. Only *after* Dubai had postponed the repayment of its bonds and we had all read about it in the Financial Times did the rating agencies realise there was a crisis and downgrade Dubai's bonds. Having failed so miserably in forecasting a sovereign debt crisis, they went on a frantic search for other possible sovereign debt crises. They found Greece, which of course was a natural target. They did not limit their search to Greece but "visited" other countries as well – mostly Southern European countries – and started the process of downgrading. This in turn led to a significant increase in government bond rates in these countries.

Hesitation and ambiguities by both the eurozone governments and the ECB also abetted the crisis as it unfolded. The eurozone governments failed to provide a clear signal about their readiness to support Greece. The failure to do so resulted mainly from disagreements among member state governments concerning the appropriate response to the Greek crisis.

The ECB, in turn, created ambiguities about the eligibility of Greek government debt as collateral in liquidity provision. As is well-known, the ECB relies on ratings produced by American rating agencies to determine the eligibility of government bonds as collateral. Prior to the financial crisis, the minimal rating needed to be eligible was A- (or equivalent). In order to support the banking system during the banking crisis, the ECB temporarily lowered this to BBB+. At the end of 2009, however, the ECB announced that it would return to the pre-crisis minimal rating from the start of 2011 on. As Greek sovereign debt had been lowered to BBB+, this created a big problem for financial institutions holding Greek government bonds, which now face the prospect that their holdings of these bonds may become extremely illiquid. No wonder many dumped Greek government bonds, precipitating the crisis. Similar uncertainties about the future ratings of other eurozone government bonds hang as a sword of Damocles over the Greek government bond market and more generally over the government bond markets of the weaker countries in the eurozone.

What's to Be Done: the Short Term

The Greek government debt crisis must be stopped. There are at least three reasons why it is imperative that this crisis be put to an end. First, allowing the Greek crisis to lead to default risks leading to a contagion that will affect other government bond markets in the eurozone. Second, and following up on the previous statement, such a contagion to other government bond markets will affect the banking sector in the eurozone. Many banks have started to recover from the banking crisis by arbitraging the yield curve, i.e. by borrowing short from the central bank at very low interest rates and investing in longer-term government bonds. The steepness of the yield curve has been an important source of profits for banks. A crisis in the government bond markets, i.e. sharply declining bond prices, would lead to large losses on banks' balance sheets, which could trigger a new banking crisis in the eurozone.

A third reason the Greek government bond crisis must be resolved is at least as important. If it continues unchecked, the crisis will lead to increases in government bond yields in a significant number of eurozone countries. This will put pressure on the governments of these countries to sharply contract fiscal policies, leading to deflationary effects and risking pulling down the eurozone economies into a double-dip recession. Such an outcome would not only be bad news for the unemployed, but would also make it even more difficult for the eurozone countries to reduce their budget deficits and debt levels.

The choice the eurozone authorities face today is between two evils. The first one arises from moral hazard. Bailing out Greece is bad because it sends the signal that irresponsible behaviour will not be punished. The second evil arises from the contagious effects on the banking system and the macroeconomic policies in the eurozone that would result from letting Greece default. Authorities have to choose for the lesser evil, which in this case is the former one. This is also what they did when they bailed out the banks that had been at least as irresponsible as the Greek government.

While there can be little doubt that the crisis must be stopped now rather than later, much doubt has been cast on whether the European Union, or for that matter the member countries of the eurozone, have the means to do so. Doubts have been raised regarding the legal authority and the financial capacity of the union to organise a bail-out.

The legal sceptics argue that the no-bailout clause in the Treaty forbids the member states of the union to provide financial assistance to another member state. But this is a misreading of the Treaty. The no-bailout clause only says that the European Union shall not be liable for the debt of governments, i.e. the governments of the Union cannot be *forced* to bailout a member state (see Article 103, section 1). But this does not preclude the governments of the EU from freely deciding to provide financial assistance to one of the member states. In fact, this is explicitly laid down in Article 122, Section 2 TFEU (ex Article 100, Section 2 TEC).[1] Thus euro zone governments have the legal capacity to bail out other governments.

There can be equally little doubt that the eurozone member countries have the financial capacity to bailout Greece if the need arises. It would not cost them that much. In the event that Greece were to default on the full amount of its outstanding debt, a bailout by the other eurozone governments would add about 3% to these governments' debt – a small number compared to the amounts added to save the banks during the financial crisis.

One can conclude that the member countries of the eurozone have the legal and financial power to bailout Greece. Up to now the only obstacle has been political, i.e. the lack of consensus among the different member states about the necessity to do so. The agreement reached at the European Summit of 25 March 2010 goes in the right direction. However, ambiguities remain, in particular with regard to the interest rate the Greek government will have to pay in a future financial aid package. The agreement stipulates that this will be the market interest rate. This leads to the problem that if the market pushes up the interest rate on Greek government bonds, eurozone countries may step in to "help" Greece using a punitively high interest rate. This surely would not help the Greek government.

1 Here is the text: "Where a Member State is in difficulties or is seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences beyond its control, the Council, on a proposal from the Commission, may grant, under certain conditions, Community financial assistance to the Member State concerned."

The Greek government of course has the key to eliminate the obstacle by providing a credible budget cutting policy. This seems to be the case now after the latest round of budget cutting measures. Despite the agreement of 25 March, it is unclear whether the other EU countries are willing to hold up their end of the deal.

Fortunately, the ECB announced on 25 March that it will continue to accept Greek government debt as collateral, independent of the ratings concocted by the agencies. This is a major contribution by the ECB to stabilising the Greek government bond market and to reducing the risk of spillovers to other markets.

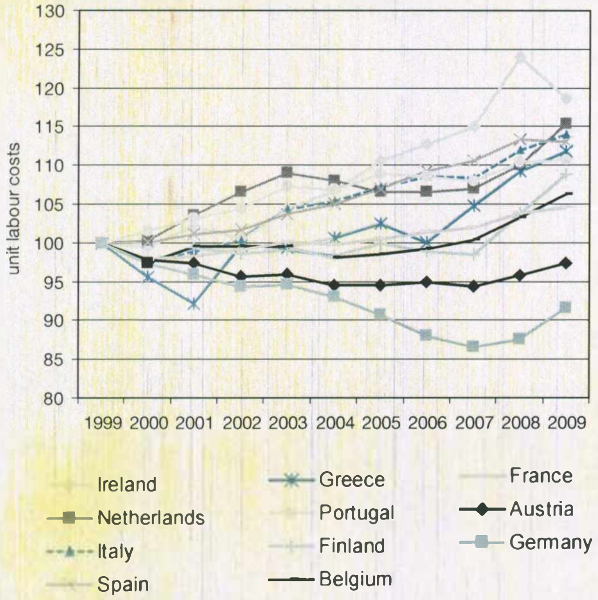
The experience we have had with ECB policy regarding the eligibility of government bonds as collateral in liquidity provisions leads to the conclusion that there is an urgent need for the ECB to change this policy. More precisely, the ECB should discontinue its policy of outsourcing country risk analysis to the American rating agencies, which have a dismal record in this field. As argued earlier, they have made systematic mistakes, underestimating risks in good times and overestimating risks in bad times. Relying on these agencies to decide such crucial matters as the selection of government bonds is simply unacceptable. It helps to destabilise the financial markets in general and the eurozone in particular. Surely, the ECB should not be a primary source of financial instability in the eurozone. Indeed, the ECB is better positioned to analyse the creditworthiness of eurozone member countries than the rating agencies are. It has a pool of highly skilled analysts who are equally if not more capable than the analysts working for the rating agencies.

What's to Be Done: the Long Term

The crisis has exposed a structural problem of the eurozone that has been analysed by many economists in the past, namely the imbalance between the full centralisation of monetary policy and the maintenance of almost all economic policy instruments (budgetary policies, wage policies, etc.) at the national level.

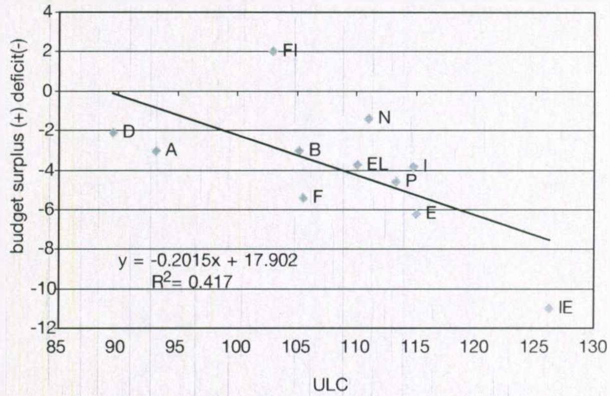
Put differently, the structural problem in the eurozone is created by the fact that the monetary union is not embedded in a political union. This imbalance leads to a dynamic of creeping divergences between member states with no mechanism to correct or alleviate them. These divergent developments have much to do with the fact that important economic decisions (decisions about wage agreements, budgetary policies, social policies, credit regulations, etc.) are made at the national level. We show the well-known divergence in relative unit labour costs in the eurozone in Figure 1.

Figure 1
Relative Unit Labour Costs in the Eurozone



Source: European Commission, Ameco data bank.

Figure 2
Relative Unit Labour Costs (1999-2008) and Budget Surplus (+) or Deficit (-)



Source: European Commission, Ameco data bank.

These divergent movements in competitiveness also lead to budgetary divergences whereby countries that lose competitiveness experience stronger deteriorations of their budgetary situations. This is shown in Figure 2. Thus the lack of political integration leads to a buildup of economic and budgetary divergences, resulting in a crisis. When the crisis erupts, the same absence of political integration makes it difficult to resolve the crisis, as illustrated above.

This structural problem has to be fixed before we are hit by the next crisis. But that is also the hard part. In the eurozone today, there is no willingness to move forward toward a more concentrated political union. Even the thought of adding just 0.1% to the European Union budget makes some countries extremely jittery. Thus, a very small scale fiscal union that would transfer just a few percentage points of budgetary and tax responsibilities appears to be out of the question.

One is led to the conclusion that the inability to create a closer political union in the eurozone will prevent it from developing beyond its current fragile construction, prone to crises and great turbulence each time such a crisis must be resolved.

While a grand plan for political unification does not seem to be possible, small yet focused steps towards such a future union can be taken. Two such steps are worth mentioning here. One is the idea of creating a European Monetary Fund (EMF), an idea put forward by Daniel Gros and Thomas Mayer[2]. The EMF would be a new European institution which would obtain its funding from countries with excessive budget deficits and debt levels. In times of crisis, it would have the means to support countries in need of financial assistance as well as the authority to impose conditions on the granting of said assistance.

Another idea is to create new common euro government bonds in which each country would participate *pro rata* of its capital share in the ECB (for more detail see De Grauwe and Moesen[3]). In order to deal with obvious moral hazard problems, the interest rate each of the participating countries would have to pay would depend on the interest rates each of these governments pay when they issue bonds in their own markets. Thus the more profligate governments like Greece would have to pay a higher interest rate than the more virtuous governments. The common bond interest rate would then be the weighted average of these national interest rates. Such a scheme would go a long way toward pacifying the moral hazard fears implicit in common bond issues, fears that are very strong in countries like Germany. In addition, by creating a new bond market with sufficient size, it would also be attractive to outside investors, creating a liquidity premium that would profit everybody, including Germany.

2 D. Gros, T. Mayer: Towards a Euro(pean) Monetary Fund, CEPS Policy Brief, No. 202, Brussels 2010.

3 P. De Grauwe, W. Moesen: Gains for All: A Proposal for a Common Euro Bond, in: Intereconomics, Vol. 44, No. 3, 2009.

These proposals are only small steps towards political unification, but they would be important signals of the determination of eurozone members to commit themselves to a future intensification of the process of political union. Such signals are of crucial importance today. They make it clear that the members of the eurozone are serious in their desire to preserve the eurozone. Without these (or similar) steps, there can be little doubt that the eurozone has no future.

Desmond Lachman

Greece's Threat to the Euro

All too often in the midst of an economic and financial crisis, policymakers either engage in denial or else take flights into fantasy. Sadly, the present Greek crisis is proving to be no exception. Rather than recognising the Greek crisis for the solvency issue that it is, European policymakers seem to be convincing themselves that foreign speculation is at the core of the crisis. And at a time when the European economic house is burning, European policymakers are now indulging in the fantasy that an inevitably tortuous Treaty modification allowing for the establishment of a European Monetary Fund will have any relevance for the resolution of the present Greek crisis.

A more realistic analysis of Greece's present economic situation would reveal that Greece now poses a very real existential threat to the continuation of the euro in its present form. This is not simply because of the extraordinarily large internal and external imbalances that Greece is now trying to address within the straightjacket of eurozone membership. Rather, it is because similar imbalances are shared to a disturbingly high degree by the very much larger Spanish economy as well as by the economies of Portugal and Ireland.

European policymakers' understandable reluctance to own up to the solvency problems facing by the countries at the eurozone's periphery will not make these problems go away. Nor will repeated bailouts of these countries do more than kick the can forward. What it will do, however, is distract attention from the most basic of questions that Europe will have to confront within the next year or two. How is the euro to be restructured in a manner that inflicts the least damage possible on the European economy?

Greece's Solvency Problem

At a time when European policymakers are contemplating banning naked CDS positions and embarking on the drawn-out process of setting up a European Monetary Fund, the Greek economic crisis is playing out in real time. At the root of the crisis is Greece's longstanding failure to remotely live up to its Maastricht Treaty obligations with respect to its public finances. Indeed, from the moment that Greece adopted the euro in 2001, the Greek authorities have been engaged in shameless creative budget accounting that evidently misled not only Greece's eurozone partners but Greek policymakers themselves.

Last October, after a new Greek government took office, markets were rudely reminded of how fast and loose Greece has been with its public spending and budget reporting. It was then that Mr. Papandreou, the newly elected Greek prime minister, shocked markets by owning up to the fact that Greece's budget deficit in 2009 would be around 12 ¾ percentage points of GDP or around double the former officially projected number. It is little wonder that of all the eurozone member countries, Greece has received the worst ratings from the credit rating agencies. It is even less wonder that the Greek government now has to pay the highest interest rates in the eurozone on its sovereign borrowing.

Greece's budget largesse has clearly put the country's public finances on an unsustainable path. This is suggested by a budget deficit that is more than four times the Maastricht criteria's limit of 3 per cent of GDP. It is also underlined by a public debt to GDP ratio that is expected to exceed 120 per cent by the end of 2010. Equally disturbing is the fact that budget profligacy, coupled with inappropriately low ECB interest rates for Greece, has resulted in persistently higher wage and price inflation in Greece than in the rest of the eurozone. Since adopting the euro in 2001, Greece is estimated to have lost around 30 percentage points in unit labour competitiveness, which has contributed to a widening in its external current account deficit well into the double digits in relation to GDP.

The sad reality is that Greece's domestic and external imbalances have reached such a dimension that their correction within the straightjacket of eurozone membership will necessarily involve many years of painful deflation and deep economic recession. Lacking its own currency, Greece cannot restore international competitiveness through currency depreciation. Nor can it use exchange rate devaluation to stimulate its export sector as a means of offseting the negative impact of massive budget consolidation on domestic demand.

In the context of an ECB that aims for price stability in the eurozone, the only realistic way that Greece can regain international competitiveness without currency devaluation is by engineering a 20-30 per cent fall in domestic wages and prices over time. This would necessarily involve many years of painfully slow economic growth and very high unemployment. It would also contribute to raising Greece's public debt to a GDP ratio beyond 150 per cent, or to a level that Greece could hardly support without a major debt restructuring.

An even surer recipe for many years of a depressed economy and extraordinarily high unemployment levels would be an attempt by the Greek government to reduce its budget deficit over the next three years by the 10 percentage points of GDP needed to bring that deficit into line with the Maastricht criteria. Even if one were to assume that the Keynesian multiplier was only 1.2 for Greece, a 10 percentage point of GDP cut in public spending must be expected to directly cause Greece's GDP to contract by 12 per cent over that period.

Since tax collections in Greece are around 40 per cent of its GDP, were GDP indeed to decline by 12 per cent, Greece would lose around 5 percentage points of GDP in tax collections. The net upshot would be that Greece's budget balance would only have improved by 5 percentage points of GDP rather than the desired 10 percentage points of GDP. This would necessitate yet a further round of savage public expenditure cuts that would only further depress the Greek economy.

Taking this line of reasoning to its logical conclusion, it would seem that if Greece is indeed to keep cutting budget spending to meet the Maastricht criteria, while at the same time getting no benefit from a depreciated exchange rate, Greece could very well see its GDP declining over the next few years by a cumulative 15 to 20 per cent. In that context, Greek policymakers might want to take a close look at the experience of the hapless Latvia, which is some eighteen months ahead of Greece in the application of a hair-shirt fiscal austerity programme under IMF supervision to preserve its euro currency peg. Latvia's GDP has already fallen by 18 per cent and the IMF is expecting a further 4 per cent decline in 2010. Equally disturbing is the fact that for all of its economic pain, Latvia's budget deficit remains around 8 per cent of GDP, more than double the desired Maastricht target.

It is difficult to believe that Greece's social and political fabric would hold together were Greece's recession to be half as deep as that being experienced in Latvia. It is also difficult to believe that a major Greek recession would not result in a wave of household defaults that would shake the Greek banking system to its very roots and that would spark the very capital flight that Greece is seeking to avoid.

Greece Is Not Alone

Within this sombre picture, there is one silver lining for the Greek government. It is the knowledge that the European Central Bank and the European Commission are as fearful of the consequences of a Greek default on the US$ 400 billion in its sovereign debt as the Greek government itself is. Not only would a Greek sovereign default deal a major blow to a still very fragile European banking system, it would also focus the market's full fury on the other highly vulnerable eurozone members. Spain, Ireland and Portugal all have very troubling public finances and international competitiveness problems that must be expected to raise serious questions in the markets as to whether they would be the next dominoes to fall.

At five times the size of the Greek economy and with around US$ 1 trillion in sovereign debt, the Spanish economic domino is Greece's most potent argument for a European bailout. In all too many ways, the Spanish economy suffers from the same sort of economic vulnerabilities as the Greek economy does. Worse still, in some ways the Spanish economy is less well placed than that of Greece to endure many years of deflationary budget policy.

Over the past decade, mainly as a result of a housing market boom that dwarfed the one in the USA, the Spanish economy has lost even more price and wage competitiveness than the Greek economy. This loss in international competitiveness has been an important factor underlying the widening of Spain's external current account deficit to a peak of US$ 150 billion, or more than 10 per cent of GDP, in 2007. It has also contributed to the exponential increase in Spain's gross external debt burden to a staggering 135 per cent of GDP at present.

Now that the Spanish housing bubble has started to burst, it has become all too evident how overly dependent Spain's public finances were on property market related revenue collections. From a modest surplus in 2007, Spain's budget position has swung dramatically to a deficit of 11 ½ per cent of GDP by 2009, a level not materially different in relative size from that of Greece.

Like Greece, Spain will be required to adhere to many years of budget austerity if it is to regain its more than 30 per cent loss in international competitiveness and to restore budget sustainability within the straight-jacket of eurozone membership. Yet Spain will have to start the budget consolidation process with an unemployment rate already close to 20 per cent. And Spain will have to engage in draconian budget cutting at the very time that the continuing bursting of its housing bubble will be a major drag on the Spanish economy. Under these circumstances, it is difficult to see how Spain's banking system will be spared a major crisis sometime down the road.

Kicking the Can Forward

A Greek sovereign debt default would almost certainly trigger severe market pressure on Spain, Ireland and Portugal, which the market would perceive as being the next countries in line to default. By meaningfully raising these countries' borrowing costs, such market pressure would make it virtually impossible for these countries to service their sovereign debt obligations. Armed with this knowledge, one can be sure that the Greek government will exert its leverage to extract a bailout from its main European partners since this is vital to staving off the European periphery's day of reckoning. Despite all of the German government's huffing and puffing about moral hazard risk and Greece's lack of policy commitment, it knows that when the chips are down, the very continuation of the eurozone experiment in its present form is in question.

Sadly, when Greece does get bailed out, be it by its European partners or by the IMF, there will be a basic question that will go unasked: are Greece's long-term economic interests best served by delaying what seems to be Greece's inevitable need to restructure its sovereign debt and to devalue its currency? Not only will a bailout needlessly put the Greek economy through the wringer and worsen the starting point from which an eventual Greek economic recovery might begin, it will also cruelly saddle Greece with a mountain of official debt that Greece will not be allowed to reschedule.

Europe in Denial

Instead of considering how best an eventual break-up of the euro in its present form might be handled, European policymakers are toying with the quixotic idea of setting up a European Monetary Fund. They do so in the full knowledge that the setting up of such a fund will require Treaty modification. And they do so knowing that, if the tortuous process of ratifying the Lisbon Treaty is anything by which to go, gaining final approval for a European Monetary Fund could take at least five years.

It is fanciful to think that markets will patiently hold onto their Greek paper while the European policymakers take their sweet time setting up an institutional change as far-reaching as the EMF. It is also difficult to see how such a fund would do anything to reverse the enormous damage that has already been done to the Club Med countries' economic fundamentals. It would seem to do little good to close the stable door now after the horse has long since bolted.

The recent strong public outcry in Germany against the notion of bailing Greece out should give one pause before suggesting the establishment of a new European Monetary Fund that should be funded by market borrowing backed by member country guarantees. The German public will rightly ask how lending by the proposed European Monetary Fund to member countries in distress would be different from the sort of sovereign bailouts that are supposed to be proscribed by existing eurozone agreements. They will also understand that it would be the German taxpayer rather than the markets that would be left holding the bag in the event of any failure by Greece to repay.

It would seem that Europe's interests would be better served if its policymakers were to recognise the basic flaws in the eurozone concept as patently revealed by the outsized internal and external imbalances of its Club Med members. The fact that the euro's founders deliberately omitted the mapping out of an exit strategy from the euro does not mean that the arrangement will not be torn asunder by the insuperable vulnerabilities of its peripheral member countries. Better that the eventual break-up of the euro in its present form occurs in a well thought out manner than in a disorderly fashion driven by market forces.