German Working Papers in Law and Economics

Volume 2012 *Paper* 1

The Sovereign Debt Crisis in Europe, Save Banks Not States

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Abstract

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Number of Pages in PDF File: 23

Keywords: Euro, European debt crisis, European Central Bank, European Stability Mechanism, Debt restructuring, Sovereign insolvency, no bail out clause, Eurobonds.

Working Paper Series

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Why the Euro?

What is the economic rationale for the Euro? Some economists with Paul Krugman being the most prominent among them maintain that there is no rationale at all and view the Euro as a purely political and even romantic project for a disparate economic zone for which a single currency fits like the saddle on the cow[2]. Provided that they are right, the Euro cannot and should not survive and hence the best strategy to end the current crisis would be to reintroduce national currencies. This would allow troubled countries to devaluate their currencies and thus regain international competitiveness.

However others, including Barry Eichengreen, one of the most knowledgeable observers of the European Union and its financial architecture think differently. In his article in the Journal of Economic Literature Eichengreen maintains that the introduction of the Euro was a consequent move after the establishment of the single European market. The European Union is not just a customs union but also a free market for services, capital and labor. The European treaties, the large body of secondary law and the decisions of the European Court of Justice have removed even the most remote barriers to enter national markets. No other collection of states has achieved this depth of market integration. The downside of this is an inherent vulnerability to sudden exchange rate changes in member countries, which can cause huge disruptive effects. This consequence of the single European market led to the introduction of the European exchange rate mechanism with almost fixed exchange rates as early as 1979. But with different inflation rates within the EU this mechanism was unstable. In 1992 both Britain and Italy heavily devaluated their currencies. This led to disruptions in the industries of other member states with huge layoffs of workers and a devaluation of the capital stock in the export as well as the import substituting industries. The consequence of this experience was the decision to take the risk of a common currency, in which such

[2] Paul Krugman, Boring Cruel Romantics, New York Times, 20 November 2011 "The truth is that Europe's march toward a common currency was, from the beginning, a dubious project on any objective economic analysis".

disruptions for investors and workers cannot occur[3]. Without the Euro it is questionable, whether the deep market integration is sustainable. It might have to give way to a form of integration closer to what we have in the GATT/WTO framework. Just to illustrate: In Greece a newly appointed schoolteacher with a University degree currently earns a salary of little less than 1000 Euro per month and 80 per cent of employees in the public sector earn between 1000 and 15000 euros[4]. Assume that Greece would reintroduce the Drachma and devaluate it by 50 per cent as analysts forecast for that scenario. The salary would then decline to less than 500 Euro per month. This might lead to massive emigration like in neighboring countries Bulgaria and Romania, or in Poland, which are EU member states but not part of the Euro zone. What would this mean for Greece with a population of 11 million and for its economic and political stability? This is unclear. Emigration causes huge workers remittances, which stabilize the economy as in India, China and Poland[5]. But a sudden wave of migration from Greece to other countries can also cause severe shortages of public services like in the German Democratic Republic before it built the Berlin wall. If for instance medical doctors, teachers and nurses would leave the country suddenly and in large numbers their remittances could not compensate for the negative effects of a decline in the availability of public services. And it is unclear and unlikely that the Greek state could impose restrictions on emigration for workers in the public service without violating European law.

Elements of the crisis

What explains the current crisis of public debt? I concentrate on the three main factors. First the Lehman crisis, which forced the Eurozone states to increase their public debt by roughly 20 percentage points[6]. Second the legal constitution of the European central bank, which makes it a lender of last resort for banks but not for states. And third the different

[3] Barry Eichengreen (1993) European Monetary Unification, Journal of Economic Literature, XXXI (3), 1321-1357

[4] Neither the International Labor Organization (ILO) nor Eurostat publish prompt wage statistics on Greece.. The following numbers are from the German Bundesagentur für Arbeit. "Die höchsten tariflichen Mindestlöhne werden mit 1.080 € brutto pro Monat in der Branche Finanzdienstleistungen gezahlt; am wenigsten – rund 683 € – verdient man in den Branchen Maschinenbau sowie Elektro- und Elektronikindustrie (Stand: 2007). Branchenübergreifend und mit bis zu drei Jahren Berufserfahrung erhält ein Ingenieur im Durchschnitt mindestens 1.034 € brutto pro Monat, ein Programmierer 702 €, ein Sekretär mit Fremdsprachenkenntnissen 717 €, ein Buchhalter 771 € und ein Fahrer 716 €." www.ba-auslandsvermittlung.de/lang_de/nn_2856/DE/LaenderEU/Griechenland, last visited at 25 February 2012

[5] Dilip Ratha (2003) Workers' Remittances: An Important and Stable Source of External Development Finance Global Development and Finance, Ch. 7

[6] From 2008 to 2010 public debts in the Eurozone increased from 66 to alsmost 85 per cent of GNP In the United Kingdom the rise was even much steeper, from 54 to 84 Prozent. See Eurostat

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development of wages in Germany and in southern European states, which have increased German competitiveness and decreased competitiveness in the south.

Without the Lehman crisis public debt in the Eurozone would not be 80 percent as it was in 2010[7] but only 60 percent of the GDP. In the South it would be higher than that in Portugal, Italy and much higher in Greece but much lower in Spain, a country with low budget deficits and even budget surpluses until the Lehman crisis. In Germany the Lehman crisis added 15 percentage points and the costs of the German unification added 20 percentage points to its public debt ratio, which would be less than 50 percent of its GNP without these two events[8]. The widespread view that the crisis reflects above all the crisis of the Continental European welfare state is clearly wrong. Sure, pork barrel legislation and campaign goodies play a big role in the troubled Eurozone countries. And everywhere in Europe we have the friendly politician, who promises every citizen an income, which is higher than the average income. But I doubt that this is significantly different in the Eurozone as compared to many other Western countries. And this becomes even more obvious, when we look at public debts in other rich countries. For 2011 the public debt estimates for the USA in the USA are 102 percent of GNP, considerably higher than in the Eurozone, 84 percent in the United Kingdom, slightly higher than in the Eurozone and 204 percent in Japan, higher than in any country in the Eurozone including Greece[9]. And none of these countries faces a similar crisis of its public debt as Spain or Italy. Also in historical perspective present public debts are not excessive as the British example tells. The ratio of British public debts over GDP after the Napoleonic wars and after World War II was about 250 per cent[10]. And this burden did neither lead to state bankruptcy nor did it cripple the British economy but disappeared with time and economic growth.

Why are some countries in the Eurozone in trouble and face high interest rates for their government bonds, whilst at the same time other countries like the USA, Britain and Japan have no problems at all to roll over their debts with interest rates around 2 percent, which in the UK and the USA are presently even slightly lower than for German government bonds? This is a consequence of the legal construction of the European central bank. The legal status of the European central bank does not allow it to signal to creditors that it will buy

[7] Eurostat, Provisions of Deficit and Debt Data, 26 April 2011
[8] Gert G. Wagner, Wir leben nicht über unsere Verhältnisse, DIW Berlin, Themen und Nachrichten, 5.12. 2012
[9] USA, The world Factbook, Central Intelligence Agency, www.cia.gov/library/publications/the-world-factbook/rankorder/2186rank.html

[10] UK Public Spending www.ukpublicspending.co.uk/uk_national_debt

government bonds with full firepower in case of a liquidity crisis[11]. In the USA, the UK and Japan as well as in almost all countries worldwide the central bank can act as a lender of last resort for the banks and -directly or indirectly- for the state and can credibly signal this to creditors as quantitative easing[12] is in principle unlimited. The European central bank cannot give the same signal. It cannot buy government bonds on the primary market and its operations to buy bonds on secondary markets are limited. This makes creditors nervous and explains the extraordinary interest rates in the troubled countries. Without betraying its legal mission the European Central bank cannot buy bonds of highly indebted countries until a target interest rate is reached. Greece is probably a special case and might have run into insolvency regardless of the institutional form of the ECB. If we had a European central bank which would lend to the states in the same way as other central banks even at the risk of inflation, the crisis would not exist. But given the legal framework every country in the Eurozone is forced to take up Euro credits almost as if they were foreign currency credits. For credits in foreign currency however a state cannot improve its debt servicing capacity with monetary instruments. It needs to increase the real GDP or the tax rate or lower state expenditures. Therefore the possibility/ability to finance the states in the Eurozone with public debt is inherently lower than in other countries. This should have been clear from the outset. The Maastricht criterion of an upper threshold of public debt of 60 percent of the GNP[13] reflects this. But neither the European Commission nor the states of the Eurozone and not even the creditors have taken this criterion seriously because of its weak enforcement mechanism[14]. Now debtors as well as creditors learn it the hard way through market forces.

The third reason for the present crisis is only indirectly related to government debt. Since the introduction of the Euro the target inflation rate announced and also realized by the ECB was 2 percent. In Germany it was a bit lower than 2 per cent and in the southern states it was a bit higher than 2 per cent during the whole period. Therefore within 11 years or more precisely since 1997, when exchange rates became fixed and interest rates converged, the international competitiveness of the German economy has steadily increased and the international

[11] Many international observers regret this with George Soros being one oft he most prominent.„Member countries share a common currency, but when it comes to sovereign credit they are on their own“: G. Soros, The Crisis&the Euro. The New York Review of Books, 17 August 2010

[12] In February 2012 The Federal Reserve held 1.7 bn. Dollars of US securities, about six times as much as the European Central Bank. See Federal Reserve Statistical Release, Februar 2012. The central banks in the UK and Japan follow a similar policy to keep interest rates down.

[13] Art. 104c Maastricht Treaty

[14] Jakob De Haan, Helge Berger, David-Jan Jansen (2004) Why has the Stability and Growth Pact Failed? InternationalFinance, Vol. 7,2, 235–260 Roel Beetsma, Harald Uhlig (1999) An Analysis of the Stability and Growth Pact, The Economic Journal, Volume 109, Issue 458, 546–571, Marco Buti , Sylvester C. W. Eijffinger, Daniele Franco Revisiting the Stability and Growth Pact: Grand Design or Internal Adjustment? CEPR Discussion Paper No. 3692

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competitiveness of the South has steadily decreased. The result was a German export surplus and an import surplus in the so called GIIPS (Greece, Italy, Ireland, Portugal, Spain) states[15]. This import surplus was easily financed with capital imports to the private sector in GIIPS states, because interest rates dropped to a historical low in these states but still remained slightly above the rates in Germany. German capital exports financed government deficits at low interest rates and private investment for instance a housing boom in Spain and Italy[16]. For several years the number of new houses built in Spain was higher than the combined total in Germany and France. Therefore capital imports from Germany helped to build up a huge capital stock in the Spanish real estate sector. But these investments quickly ran into diminishing returns. Spain ultimately had a huge incremental capital stock, which generated little if any national income, but the interest for the mortgage loans had to be paid. By the same token since the introduction of the Euro the investment rate of the German economy went down to 5 percent of the national product with a savings rate of about 10 percent, the remaining 5 percent was capital export. In other words the huge German export surpluses prevented the growth and modernization of the capital stock and retarded growth in Germany. The introduction of the Euro therefore had the perverse effect of building up a huge but unproductive capital stock in southern Europe whilst preventing the growth of the German capital stock and the modernization of the German economy. German banks found it more attractive to buy toxic assets in the USA and to lend money to banks in Southern Europe rather than financing firms in Germany. This was certainly an unintended consequence of the Euro, a loose-loose combination. It was good for Audi or Siemens, but it was equally bad for the German economy and for the economies in the South.

Why did this happen and why did the South loose competitiveness? Since the introduction of the Euro wage rates in the South increased much more than in Germany. Within those 11 years per unit costs of labor increased by 5 percent in Germany and by more than 30 percent in the southern countries. This increased German exports and dampened German imports from the southern countries. I believe that the Euro is not sustainable and will not survive if this problem of diverging competitiveness cannot be fixed, regardless of which decisions the governments take with regard to budget deficits. A common currency is not sustainable if per

[15] See OECD Economic Outlook November 2011, pp and 21.

[16] Hans-Werner Sinn (2006) The Pathological Export Boom and the Bazaar Effect: How to Solve the German Puzzle, The World Economy, Volume 29, Issue 9, 1157–1175,

unit wage rates diverge substantially over a long period of time. The way out would be to increase wages in Germany and to reduce wages in the south.

Let me now turn to the financial remedies, which, are discussed during the present crisis, Eurobonds, the role of the central bank, the European Financial Stability Facility, the European Stability Mechanism, and the instrument of a sovereign insolvency procedure.

Eurobonds

Eurobonds would pool the public debts of all countries in the Euro zone. The former Eurocrat Jakob von Weizsäcker and many others have proposed such bonds as a solution to end the European debt crisis[17]. These include Romano Prodi, Jean Claude Juncker and Jose Manuel Barroso to name just a few. The European commission proposed Eurobonds in a recent green paper in November this year. What would be the consequence of converting all Euro zone public debt into Eurobonds with a joint and several guarantee of liability? The interest rates for Greek, Irish, Spanish, Portuguese and Italian government bonds would fall dramatically as a result of a diminishing insolvency risk. Overall, this would imply a vast relief for the crisis struck countries. Those states, which are currently paying between seven and fourteen percent interest on their debt would perhaps manage to cope with three per cent. Consequently the solvent states such as Germany or the Netherlands would have to pay higher interest rates, since the additional risks would be priced into the new uniform interest rate. For example, in the event that the introduction of Eurobonds were to raise interest rates for German government bonds by one percentage point above the level without Eurobonds, this would amount to 20 billion Euros of additional interest payment per annum. It would not place Germany in a precarious debt situation; however it is equivalent to an increase of the value added tax by 2 percentage points.

Would this save the Euro? It all depends on how much autonomy will remain with the member states within the Euro zone in terms of assuming government debt. If everything else remains unchanged, any state may go into further debt to any desired extent. This is the counterargument of those, who maintain that the legal checks to curb

[17] Christian Keuschnigg (2012) Welche Finanz- und Wirtschaftspolitik braucht Europa? University of St. Gallen, Discussion Paper no. 2012-01, S. Eijffinger: Eurobonds nogtoekomstmuziek, in: Za- kelijgNieuiws v. 4.8.2011; J. Alpha, J. von Weizsäcker: Das Blue Band Konzept und seine Implikationen, Friedrich Ebert Stiftung, Perspekti- ven, Juni 2011; W. Bonstra: Can Eurobonds solve EMU's problems? Rabobank, August 2011; P. de Grauwe: Managing a fragile Eurozone, in: CESifo Forum, 12(2), 2011, S. 40-45; G. Horn: Die schwachen Argumente der Eurobonds-Gegner, in: Die Zeit-Online, 24.8.2011.

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deficits do not work or are not credible and that therefore automatic economic checks in the form of increasing interest rates would have to be in place.

Eurobonds would create huge incentives to continue borrowing beyond any measure, because in the event of a state bankruptcy, the costs can be offloaded to others. In the short term Eurobonds would certainly bring relief, but in the long run they might lead to a financial distress within all countries of the Euro zone and to a disaster for all countries.

Luxembourg's prime minister and chairman of the Euro Group Jean-Claude Juncker[18] as well as the recent green book of the European commission proposed to convert all non-government debt into Eurobonds up to a volume of 60 percent of a state's national product. The president of the European commission has made similar proposals[19].

Hence a country, which has 120 percent of public debt like Italy would be able to convert half of its debt into Eurobonds. If this would lead to a drop of interests from 6 to 3 per cent this alone would reduce Italian interest payment for public debt by some thirty billion Euros per annum. The remaining half would continue to have the underlying state as sole debtor. Creditors would then have to accept the default risk on the latter half of the debt. Arguably if the new stability pact negotiated by the heads of state in December this year would really work, the remaining risks for the guaranteeing states would be low. However, the new stability mechanism is untested. All decisions still remain with the council of finance ministers, the same council which was responsible for the destruction of the stability and growth pact, which seemed to be written in stone. Moreover, it gives little consolation that the German minister of finance was the main evildoer during this process of destruction. To this date, the only successful mechanism that has effectively checked government lending, has been the effect of additional credit on the interest rate of government bonds.

What about the legal problems pertaining to Eurobonds? They raise questions of European and of national constitutional law. Art. 125 of the Lisbon treaty reads: "A Member State shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, … of another Member State". The same rule holds for he European commission.

Most legal scholars agree that this so called "no bail out clause" does not rule out direct credits of member states to another distressed member state as in the case of Greece or

[18] Wirtschaftswoche, 21.11. 2011
[19] European Commission, Green paper on the feasibility of introducing Stability Bonds, Brussels, 23.11.2011

Ireland. It also does not rule out multilateral credits channeled through a European organization as the ESM. Joint liability Eurobonds would however violate the treaty and would therefore require a treaty amendment. This interpretation of Art. 125 is widely shared. Also the European commission, which has strongly been in favor of Eurobonds since the outset of the crises wrote in its green paper in November 2011 "Issuance of Stability Bonds (the commission's name for Eurobonds) under joint and several guarantees would a priori lead to a situation where the prohibition on bailing out would be breached. In such a situation, a Member State would indeed be held liable irrespective of its 'regular' contributing key, should another Member State be unable to honour its financial commitments. In this case, an amendment to the Treaty would be necessary."[20]

The meeting of the heads of state in Brussels on 8 December showed how difficult it is to change the treaty even at the level of the heads of state. They took a decision not to change the Lisbon treaty at all but to agree on a new international treaty which comprises the member states of the Euro zone plus some others who want to join the Euro group. This will probably become an international treaty, similar to the Schengen agreement.

And this new treaty remains silent with regard to the question of Eurobonds and joint liability. There is nothing in it, which uplifts the no bail out clause of Art. 125. Therefore the new treaty imposes stricter fiscal discipline on the states of the Eurozone than on other EU member states. But it leaves article 125 of the Lisbon treaty unchanged.

The necessary change of the no bail out clause, which could pave the way for Eurobonds is not in sight. So far the following EU countries have announced that they oppose Eurobonds: Germany, United Kingdom, Finland and the Netherlands. The necessary consent in the European council to change Art. 125 is not in sight at this point in time.

This is however not the only hurdle. If the heads of state of all 27 states in the EU would all agree on the change of article 125, it would still be questionable, whether this change would be ratified in all countries. There are some well known problems with regard to ratifying a change of the EU treaty. I focus here on a particular problem of constitutional law in Germany. The German constitutional court had to decide on the constitutionality of the European Financial Stability Facility, which was declared to conform with the German constitution. But without mentioning the word "Eurobonds" in its decision of 7 September 2011 it stated in an obiter dictum. "The (German) Federal Parliament is not entitled to

[20] Ibid, p. 12

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establish permanent mechanisms of international law, which result in a liability for acts of other states, especially if the consequences of the risks involved are difficult to assess."[21] It is therefore possible and even likely that the constitutional court will rule down the ratification act of the German Federal parliament as unconstitutional, if this were to allow for joint liability bonds and if the court believes that "the risks are difficult to assess". Should this happen it would imply a major drawback for solving the European debt crisis.

Assume for the sake of argument that all these legal problems can be overcome, there would still be a political constraint in Germany. The present government is a coalition government supported by the Christian democrats and the liberal free democratic party. The latter party made it clear that it will not support Eurobonds in parliament[22]. If nevertheless the German government would propose to introduce such bonds, chancellor Merkel would lose her majority in parliament, without which she cannot govern. Consequently new elections would have to follow before Eurobonds could be introduced. After elections the chances might be better as both the green party[23] and the social democratic party have announced their support in favor of Eurobonds under the condition of better fiscal discipline in the Eurozone[24]. And according to opinion polls they are likely to succeed the present government. Given these legal and political constraints I think it is credible that the German chancellor Merkel, who carefully avoids to rule out Eurobonds as a matter of principle maintains that Eurobonds cannot help as an instrument to overcome the present crisis.

European Central Bank

What about the European Central Bank? Can it solve the crisis by buying bonds from troubled countries on the secondary market? Probably it could. I mentioned before that we would not have the crisis, if the European Central Bank were able to act as a lender of last resort for the states such as the central banks in Japan, Britain and the USA. And especially the USA and Britain use this strategy. The Federal Reserve Bank[25] has bought 6 times as many bonds as the ECB and the bank of England much more than the ECB[26]. If the ECB

[21] http://www.bverfg.de/entscheidungen/es20111027_2bve000811.html (own translation from German)
[22] FDP im Deutschen Bundestag, Eurobonds mindern Anreize, Press release 23 November 2011
[23] Die Grünen, Bündnis 90, Bundestagsfraktion, Press Release, 30 November 2011
[24] www.spd.de/aktuelles/Eurobonds (last visited 28 February 2011)
[25] See above FN. 11
[26] 325 billion Pounds until 9 February 2012, Bank of England, Statistics, http://www.bankofengland.co.uk/statistics This is almost 80 per cent more than what the ECB holds from distressed countries.

would follow the same policy it could for instance announce to buy Italian bonds until the underlying interest rates dropto a particular level. But the Maastricht treaty, which established the ECB, carefully rules out this possibility. Article 123 of the treaty on the functioning of the European union prohibits direct credits from the central bank to any member state and the purchase of government bonds on the primary market.

When the ECB under president Trichet started to buy bonds of distressed countries some observers regarded[27] this as a circumvention of the prohibition of Art. 123. This practice actually triggered the resignation of the former president of the German Bundesbank Axel Weber. In order to see whether these critics are right we have to look at the Lisbon treaty.

(Art. 127) of the treaty reads „The primary objective of the European System of Central Banks shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Union“. This is a flexible formula and the ECB hast he right and even the duty to help the general policy of member states, as long as this does not interfere with its primary policy target, price stability. And President Trichet was fully in line with the general economic policy as the European governments, including France and Germany supported or at least did not oppose the purchase of bonds from distressed countries. And thusfar neither under the leadership of president Trichet nor under the present leadership of president Draghi, has the purchase of bonds from distressed countries had any inflationary effect. The money base remained unaffected because the central bank sold other assets of the same value and therefore sterilized the consequences of buying bonds from distressed countries. In my view therefore the ECB has so far acted strictly within the confines of article 127.

As long as the European Central bank continues to buy bonds of distressed countries on the secondary market and sterilizes its effects by selling other assets it acts within the institutional framework of Art. 127. This policy poses additional risks to countries of the Eurozone in case one of the debtor states needs a debt restructuring. This would lead to a write off and reduce the central bank’s profits and the member states’ share therein. In this case it would have a direct negative effect on the budgets of the member states. But so far no government of the Eurozone has criticized this risk seeking behavior of the ECB. The ECB can therefore trust that it supports the general policy of the member states and therefore acts

[27] In a letter of the former president of the German Bundesbank Axel Weber to the members of the Central Bank Council he criticized the purchase ob government bonds by the ECB as a „clear violation oft he treaty“ See Wall Street online 15 August 2011.

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fully in line with article 127. So far the Central bank has bought bonds from distressed countries worth 218 billion Euro[28]. How long can it proceed with this policy without risking inflation? This is debated but the possibility to sterilize these effects gets exhausted at some level. There is no reason to believe that the ECB has any plans to deviate from the treaty obligations. The new president Draghi made it clear in several statements that nobody can give him any instructions thereby alluding to art. 130 of the treaty on the independence of the central bank. He also stressed that the role of the central bank to help distressed countries in this crisis is limited[29]. There is therefore no indication that the European Central Bank will cross the red line and take the risk of inflation. In this respect the British and US approach to the crisis fundamentally differ from the approach in the Eurozone.

The European Stability Mechanism (ESM) and the European Financial Stability Facility (EFSF).

Should these observations be right it will be impossible to introduce Eurobonds within the next 2 years and the European central bank can and will intervene only with limited firepower within the confines of its primary stability orientation. This triggers the question, whether or not the other financial resources to fight the crisis are big enough to help distressed countries to avoid a state insolvency including debt restructuring?

The European financial stability facility has a volume of 780 billions, but only on paper. If the contributions of those countries currently in distress are deducted, the lending capacity is only 440 billions[30]. Issuing bonds will leverage this to 1 trillion Euros. Any further extension, for instance by means of granting a bank license to the ESM, was denied. A bank license would have allowed the ESM to borrow money from the European Central Bank and then lend this to distressed countries.

On top of this one billion comes the fire power of the European central bank, which is however limited and I guess that it will not surpass 400 billion Euros. On Top of this come potential credits from the International Monetary Fund. Also, the 17 central banks within the Eurozone have agreed to make additional contributions to the International Monetary Fund. The amount of these contributions is still unclear but it will exceed 150 billion Euros. The

[28] Until the 8th week 2012, European Central Bank, Statistics http://www.ecb.int/stats/
[29] Draghi: EZB kann Euro nur begrenzt helfen, News.de, 1 December 2012
[30] www.efsf.europa.eu/about/index.htm

German share of this contribution is 46 Billion Euros[31]. This sum can again be leveraged by the IMF and and the IMF can lend the leveraged sum to European countries in distress. Some of this money is already spent on the rescue packages for Greece, Ireland and Portugal. The remaining sums available for future efforts to stabilize all distressed countries in the Eurozone will be lower than 1.5 trillion Euros, including the IMF credits. However, the total public debt of distressed countries in the Eurozone is 3.6 trillion Euros[32].

This leads to a simple calculation. The lending capacities of the IMF, the European Central Bank and the European Stability mechanism would be big enough to help Greece, Ireland, Portugal and Spain. They would also be big enough to help Italy for the forthcoming year, in which Italy has to roll over 300 billion of its public debt. If however this money is spent and if this is not enough to avoid a state insolvency in Italy, we are faced with the danger of messy state insolvencies in 2013.

How can this be avoided? It is difficult to imagine that all 17 parliaments in the Eurozone would agree to further increase the capital endowment of the European Stability Mechanism. If this observation is correct, three possibilities remain: either the sudden introduction of Eurobonds, or unlimited purchases of bonds by the ECB or a debt restructuring in distressed countries.

What is the best choice between these three evils? Such operations are emergency surgery and the rules of emergency surgery are different from the usual rules of medicine. Normal medicine tries to lead the patient to the best possible state of health. Emergency surgery attempts to keep the patient alive for the next hours or even minutes. There is a tradeoff between the optimal rules of emergency surgery and the optimal rules for general medicine. But if one compares different methods of emergency surgery one still has to rank them.

Eurobonds would immediately restore the creditworthiness in the short run. Can they be introduced in the short run? Given the legal constraints which I have elaborated on earlier, this is questionable. But what would be the consequences of Eurobonds if they were introduced? Eurobonds are the worst alternative because they will probably be irreversible when the crisis has been overcome. Eurobonds would burden the triple A rated countries with the unimaginable sum of about 3.6 trillion Euros at risk. These countries would therefore have no other choice than to try to impose an iron fiscal discipline on all other countries with

[31] Die Welt, 31.12.2011

[32] For the end of 2010 the figure is 3.2 Billion Euros, See OECD, StatExtracts. In 2011 the additional lending fort he PIIGS states is estimated at

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direct intervention of national budgets either by the European commission or the management of the European Stability Mechanism. This would imply a big push towards fiscal centralization in Europe, a higher centralization than in the USA or Switzerland, where such bonds do not exist. It will be difficult if not impossible to reverse this trend after the crisis to abolish the Eurobonds and restore more fiscal autonomy.

What about the central bank? If the central bank crossed the red line and bought unlimited amounts of bonds to avoid messy bankruptcies of member states thus increasing the risk of inflation, this would be a violation of the Lisbon treaty and it would burden all citizens in the Eurozone, whose wealth and real income is dependent on stable money. But the Central bank can easily return to its mission of price stability after the crisis. And unlike the European parliament and the commission it has an incentive to do so, because adhering to the rules increases the independence and prestige of the central bank and its board members. From this perspective the social ranking between Eurobonds and a more active role of the central bank is clear. A temporary deviation from stability policy by the central bank can more easily be corrected than the introduction of Eurobonds, once the crisis has been overcome.

However, it is risky for the central bank and for the success of its crisis management to break the rules. Any member state might take action against the ECB at the European Court of Justice. Article 263 of the Lisbon treaty gives member states a standing in court against the ECB. It is however unclear and disputed, what a state can claim. Any claim against an organ of the EU must be based on a particular action. The Lisbon treaty explicitly rules out the treaty violation procedure as an action against the central bank, a tribute to its independence. A state can only base a claim on a nullification procedure. This is possible if an act of an organ of the European Union violates an entitlement or right of the claimant. But what should be nullified here? If the central bank buys bonds of a troubled state, the legal form of this policy is a sales contract with a bondholders, which certainly does not violate any entitlement of a member state and therefore cannot be nullified. One could then argue that the policy of the European Central bank is based on committee decisions of the central bank council and that such a decision can be nullified. But here the problem arises that the committee decision again does not directly infringe a legal position of a member state. Here we are on untested legal ground. In any case it is thinkable that a member state brings the central bank to court and the court nullifies a policy decision of the central bank council, if this violates the treaty of Lisbon. Such a decision could cause a mess in financial markets.

Can a European citizen take action against the European Central Bank? Citizens have standing in court, if illegal acts of a community organ, including the central bank directly effects them (Art. 263) . But courts worldwide do not regard inflation as a property violation in the legal sense. In the event of hyperinflation this might be different. Therefore there is no danger that citizens might strike down an emergency operation of the central bank at the European Court of Justice..

The third emergency option is a debt restructuring in the troubled countries a so called haircut. This would lead to huge losses of banks, investment funds, pension funds and hedge funds around the world. Given the size of the Italian economy and its debts of 1.9 trillion Euro this would lead to a bankruptcy of many of these institutions. To avoid a conflagration many of these institutes would have to be rescued and recapitalized by the European taxpayer, but also by tax payers in the UK, USA and other countries. Lucke has recently estimated that the costs for the European taxpayer would be a small fraction of the costs needed to avoid a state insolvency because the equity capital of financial institutions in the Eurozone is at risk first[33]. This capital would would disappear once the bonds have to be written off. This is also the only remedy in line with the principles of a market economy, which allocate risks to the owner of capital at risk and provides the right ex-ante incentives for creditors.

The distributional effects of European state insolvencies would agonize other countries outside the Eurozone, especially Britain and the United States. Only a part of these credits are held by financial institutions within the Euro zone. The costs of this solution –as compared with Eurobonds and inflationary policy- would be born by equity holders of financial institutions and by taxpayers in many countries. The European taxpayer would however save money compared to the other options. The institutional framework for such a solution will be in place as soon as the European Stability mechanism is established, probably in mid 2012.

The second protocol of the European Stability Mechanism contains elements of a state insolvency procedure, which consists of elements from private as well as international law. It consists of three basic elements. First: The procedure opens, when a debtor country applies for a credit from the ESM. This also imposes a kind of standstill for the creditors, especially an obligation to extend overdue credits. Second: A team of experts from the EU commission, the European Central Bank and the International Monetary Fund prepares a report for the

[33] Harald Hau und Bernd Lucke, Zwangskapitalisierung gefährdeter Banken, die Alternative zum Rettungsschirm, Frankfurter Allgemeine Zeitung, 28 September 2011

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council of the ESM. In exceptional cases this results in a haircut or private sector involvement[34]. Third: the legal basis for these negotiations between the debtor country and the creditors will be collective action clauses, which will be part of all future bond contracts with governments in the Eurozone. These collective action clauses allow a supermajority of debtors to forgive parts of the debt and they also transfer the rights of legal action against a debtor from the individual bondholder to a trustee. The latter excludes disruptive activities of so called maverick funds and law firms against foreign assets of the distressed debtor state. Only after the negotiations of a haircut the ESM credits will flow if finance ministers come to the conclusion that the crisis is an insolvency crisis and not a liquidity crisis.

Assume now that the crisis unfolds over the next 2 years and the only possibility to save the Euro would either be to introduce Eurobonds, or an active role of the ECB or a haircut in the framework of the ESM, the ranking of alternatives should be clear. The haircut combined with a rescue net for financial institutions would be better than inflation caused by the ECB and inflation in turn would be better than Eurobonds with their long lasting effect on the loss of financial autonomy and a drive towards fiscal centralization with an erosion of national democracy without replacing this by more democratic European decision procedures.

A haircut would agonize governments outside the Euro area because their financial institutions would also suffer and they might have to fix problems of recapitalizing banks with their own taxpayers' money. This prospect is one of the reasons why western countries outside the Eurozone try to push governments in the Eurozone to even larger rescue funds and urge the central bank to buy bonds on the secondary markets. They do not want to share the risk. But a debt restructuring can be the solution with the least overall disruptive effects and would provide the right ex ante incentives. And after the Lehman crisis, which placed such a high burden on Europeans it is only fair to shift back some of the burden if necessary. I might quote Adam Smith here who wrote in the Wealth of Nations "When it becomes necessary for a state to declare itself bankrupt, in the same manner as when it becomes necessary for an individual to do so, a fair, open and avowed bankruptcy is always the measure which is both least dishonourable to the debtor, and least hurtful to the creditor" [35]

Before I close I get back to the most disturbing underlying cause of the crisis, which I mentioned at the beginning, the growing disparity of per unit labor costs in Germany and the South. This leads to an increasing international competitiveness in Germany and a declining

[34] EU, Treaty Establishing the European Stability Mechanism, 2 February 2012
[35] Adam Smith (1776). The Wealth of Nations, pp. 564–565. New York 2009

international competitiveness as well as a loss of employment in the South. If this problem cannot be fixed any cure in the financial sphere cannot work in the long run as long as we have a common currency. This problem cannot be solved quickly. It will take years. The survival of the Euro will ultimately depend on whether Europe can successfully solve this problem.

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