

European Council decisions on the prevention and resolution of future sovereign debt crises

The current debt crisis in several euro-area countries has revealed the inadequacy of the existing rules for preventing and resolving such crises. In light of this, on 25 March 2011, the European Council adopted a comprehensive reform package with the aim of enhancing the existing procedures. The guiding principle was to maintain the fundamental framework of monetary union and, in particular, affirm the member states' national autonomy for their own fiscal policy as well as investors' individual responsibility for their investment decisions.

Essentially, the Council resolved to change the Stability and Growth Pact, introduce both a procedure for macroeconomic imbalances as well as the "Euro Plus Pact", and to set up a European Stability Mechanism.

The overall assessment of the reform package is mixed. The reforms significantly expand the prevention and crisis resolution procedures and strengthen coordination. Although the proposed enhancement of prevention is a step in the right direction, the approach appears to be too cautious, particularly with regard to the Stability and Growth Pact. The effectiveness of the preventive measures still crucially hinges on the political will to resolutely implement the agreed rules. In this respect, given past experience, the new rules do not inspire much optimism. The decisions regarding the crisis resolution mechanism have resulted in risks being "communitised" to a greater extent. Here too, the stringency and effectiveness of the procedures ultimately depend primarily on the actual future implementation thereof. Some aspects have yet to be finalised. The outstanding decisions on these unresolved issues should lead to a strengthening of the stability-oriented policy framework of monetary union, with better incentives for sound fiscal policies and effective disciplining by the financial markets.

Package as a whole aims at better prevention and crisis resolution

The current debt crisis in several euro-area countries has revealed the inadequacy of the existing procedures for preventing and resolving such crises. The European Council has responded to this with a package of reforms, which, however, does not affect the fundamental framework of monetary union. Thus the no bail-out principle, in particular, has been expressly affirmed and with it member states' national autonomy for their own fiscal policy as well as investors' individual responsibility for their investment decisions. The reform package essentially comprises changes to the Stability and Growth Pact (SGP), the introduction of a procedure for macroeconomic imbalances as well as the "Euro Plus Pact" (EPP), and the establishment of a European Stability Mechanism (ESM).¹ Overall, the prevention and crisis resolution procedures have been significantly expanded. However, the stringency and effectiveness of the procedures ultimately depend primarily on the actual political implementation thereof. In this respect, given past experience, this does not inspire much optimism. With regard to the issues still to be clarified and the substantiation required, the fundamental framework of monetary union should be strengthened. The incentives for sound fiscal policies should be increased and the conditions for effective disciplining by the financial markets improved, instead of extending the "communitisation" of risks even further.

Incentives for sound fiscal policies still to be increased

Risk of too cautious SGP reform

Reforming the SGP is essential to improving the prevention of future sovereign debt crises. The key elements envisaged to achieve this objective are a somewhat more stringent sanction mechanism and a greater obligation

to comply with the debt criterion. In future, it will be possible to already impose financial sanctions under the preventive arm of the pact – although only in the form of interest-bearing deposits. Overall, SGP sanctions can therefore be gradually stepped up from increased reporting requirements first to interest-bearing and non-interest-bearing deposits and then to fines. Although the European Commission will, at times, have a somewhat greater say in the decision-making process in future as a result of modifications to some Council voting rules, the Council will still have the last word, meaning that there has been no significant increase in automaticity. Furthermore, details of the debt criterion have been specified. However, owing to numerous exceptions, it is doubtful whether it will be more binding. Moreover, the fact that the deficit criterion is to be eased vis-à-vis the existing rules if the debt ratio falls below the reference value should be viewed critically. Although the European Council's reform plans still have to be negotiated with the European Parliament before they are adopted by June, overall there is a risk of the reform turning out to be too cautious.² The effectiveness of the rules will continue to hinge on the political will to apply them strictly.

In addition, the stability of the euro area is to be safeguarded, first, by introducing a pro-

Procedure for macroeconomic imbalances...

¹ The decisions are published in the conclusions of the European Council from 25 March 2011. The ESM regulations can be found in annex II. The procedure for macroeconomic imbalances and the changes to the SGP are to be agreed between the European Council and the European Parliament by June.

² For more information on the SGP reforms, see: Opinion of the European Central Bank of 16 February 2011 on economic governance reform in the European Union (CON/2011/13).

cedure for macroeconomic imbalances on the basis of Article 121 (4) of the Treaty on the Functioning of the European Union (TFEU) and, second, by the EPP, a political agreement concluded by the Heads of State or Government of the euro-area countries and other member states that have not introduced the euro as legal tender. The new Union-law-based procedure for macroeconomic imbalances is, in principle, a sensible addition to the SGP, which focuses on fiscal policy. It consists of two stages. The first comprises an early warning system based on a limited number of indicators which are designed to detect external and internal macroeconomic distortions at an early stage. If a more in-depth country-specific investigation is initiated as a result and this reveals serious imbalances, the second stage of the procedure involves increasing political pressure on the country to implement economic policy recommendations aimed at correcting the distortions. At this stage, it will also be possible to impose financial sanctions if the recommendations are not heeded.

... and EPP aim at better prevention

Going beyond Union-law-based measures, the EPP, a political pact agreed by the Heads of State or Government, aims, in particular, at introducing reforms to improve competitiveness, promote employment and ensure the sustainability of public finances and financial stability. A further objective is to improve tax policy coordination. However, the specific focus of policies remains the sole responsibility of each member state. In addition to the euro-area countries, for whom participation in the pact is compulsory, EU countries that do not belong to the euro area may also par-

ticipate. Progress towards the objectives will be politically monitored by the Heads of State or Government of the participant member states. In line with its political nature, the pact envisages no binding recommendations or sanctions.

Since neither procedure alters existing competences in the area of economic policy, but, as a rule, keeps them under national jurisdiction, the discussion should focus on problem cases that pose risks for other EU countries and, in particular, euro-area member states. In so doing, measures that weaken high-performing countries should be avoided, as should attempts at macroeconomic fine-tuning, which run a high risk of not being successful owing to diagnostic problems and implementation difficulties in the politicised process.

Focus on stability-related problems appropriate

Furthermore, in order to avert a threat to the stability of the euro area, the crisis has shown that it makes sense for a crisis resolution mechanism to be kept in reserve for contingencies in which the preventive instruments prove insufficient. However, the fundamental institutional and regulatory framework of EMU must likewise be observed here. In particular, the incentives for member states to pursue sound fiscal policies and the disciplinary function of the financial markets should not be revoked.³

Introduction of a crisis resolution mechanism makes sense in principle

If the stability of the euro area as a whole is at risk, the ESM is to be permitted to provide

³ See also Deutsche Bundesbank, Towards a European Stability Mechanism, Monthly Report, February 2011, pp 64-65.

Important cornerstones of the ESM agreements

liquidity assistance to distressed countries under certain circumstances. Financial assistance (in the form of assistance loans and, in exceptional circumstances, primary market purchases of government bonds of the affected countries) is only to be granted if the distressed country complies with strict economic and fiscal policy conditions. The ESM is of an intergovernmental nature and will be established by virtue of an international treaty. Depending on the member state's legal provisions governing the treatment of international agreements, the treaty may require ratification by the national parliament. This is the case in Germany. The requirement for unanimity on key issues resolved by the decision-making bodies of the ESM means that each country will have a veto right for future assistance programmes, too. This is very important, particularly for those countries providing assistance. Furthermore, the political agreement conferring preferred creditor status to ESM loans means that taxpayers in the countries providing assistance are protected to a certain extent against losses. Moreover, from mid-2013 onwards, uniform collective action clauses (CACs) are envisaged for all euro-area government bonds with a maturity of more than one year, thereby facilitating the involvement of the private sector in the case of solvency problems.

Arrangements problematic for some key points or still to be specified in detail

However, some of these cornerstones of the ESM have yet to be specified in detail and the arrangements for a number of other key points are problematic. During the course of further implementation, it should be ensured that the above-mentioned basic structures are not impaired, so that incentives for sound

fiscal policies and for disciplining by the financial market, which have in any case been weakened in some important respects by the agreements reached up to now, are not reduced any further.

Interest rates on ESM loans are to be set only two percentage points higher than the funding costs of the ESM for the first three years (to be increased to three percentage points after three years). Compared with the premiums originally agreed within the framework of the European Financial Stability Facility (EFSF), this amounts to a reduction in the price of assistance loans of around one percentage point. The threshold for the utilisation of rescue programmes is thereby lowered and the incentives to return to the capital market are reduced. Moreover, the premium is now considerably lower than that of comparable IMF loans – although these are senior to ESM loans and are therefore less risky. Furthermore, the rules currently envisaged do not rule out the possibility of the ESM's Board of Directors easing the interest rate conditions even further. In order to limit any misguided incentives due to favourable interest rate conditions, it is all the more important to make sure that the conditionality of the assistance is strictly applied and complied with. The way in which conditionality is already enforced in the existing EFSF is likely to have a lasting impact on these incentives. In light of this, it is essential that EFSF loans are only granted if a credible and resolute adjustment programme is adopted and correspondingly implemented by the country seeking assistance.

Lowering of interest rate premiums reduces incentives for sound fiscal policies

Ensure solvency is a mandatory requirement for assistance

The mandatory participation of private creditors in cases where there are solvency problems is a key element in order to curb the expectation of fiscal policymakers and financial market players that the debt will be assumed by a third party, and thereby maintain the disciplinary function of the market.⁴ In the case of solvency problems, any assistance provided without the mandatory participation of private creditors could contravene the no bail-out provision, and transfers to beneficiary countries and financial investors would be even greater than in the case of liquidity assistance. With regard to the involvement of private creditors in establishing fundamental fiscal sustainability, the agreement that has now been reached appears less clear than the decisions made in December 2010. Therefore, before the agreement is concluded, it should be ensured in no uncertain terms that, in addition to consolidation measures, solvency is made a mandatory prerequisite for the provision of assistance and, if necessary, is to be re-established by involving private creditors to an appropriate extent.

Capital contributions to be invested only in paper with a first-class credit rating and range of instruments to be defined

The decision of the European Council does not envisage any secondary market purchases to support countries with financial problems. However, it has not yet been explicitly defined how the capital contributions to the ESM in the amount of €80 billion are to be invested. If secondary market purchases are to be dismissed as a possible means of providing assistance,⁵ a provision stating that ESM funds may only be invested in paper with a first-class credit rating would be required. Moreover, it is surprising that the Board of Directors of the ESM appears to have been

given considerable room for manoeuvre to make unspecified changes to the ESM's range of instruments. Whether any future changes will need to be endorsed by the respective parliaments will depend on what form the national ratification documents take.

Furthermore, the current decisions do not specify transparent rules for the primary market purchase instrument. It is therefore unclear whether these can be used as an extension of the support provided and thus be subject to more lenient conditions than other financial assistance measures. If this possibility is to be ruled out, it should be stipulated that both the mandatory conditionality and the preferred creditor status for ESM loans apply in equal measure to primary market purchases. Furthermore, it should be stated that assistance provided by means of primary market purchases may also not be used for anything more than financing deficits and refinancing maturing debt instruments. This framework should not be extended to permit sovereign debt buybacks on the secondary market by the beneficiary country.

Furthermore, it is important to define the application of the respective majority voting rules in the ESM's Board of Directors and

Finalise framework for primary market purchases

Define majority voting rules and total amount of liability

⁴ For more details, see a proposal on the introduction of an automatic extension of the maturity of outstanding bonds, at the same conditions, which would be included in the issuance terms of government bonds: A Weber, J Ulbrich and K Wendorff, *Krisenhilfe ohne Gemeinschaftshaftung*, Frankfurter Allgemeine Zeitung, 3 March 2011, p 12 (English translation available at http://www.bundesbank.de/presse/presse_aktuell.en.php).

⁵ For background information, see Deutsche Bundesbank, The debate on secondary market purchases by the future European Stability Mechanism, Monthly Report, February 2011, pp 68-69.

Board of Governors. It seems sensible for unanimity or a qualified majority (80% of the weighted votes) to be required for all important decisions. So as to avoid a conflict of interests, it appears necessary for those member states that are already receiving or are in the process of applying for assistance not to be given voting rights, as is currently the case for unanimous decisions made within the framework of the EFSF. In this context, no clear upper limit appears to have been set for the individual countries' total amount of liability. With regard to the capital contributions, in the case of losses, the ESM's Board of Directors appears to require only a simple majority to call in additional contributions or, in individual cases, these contributions may be called in automatically and a subsequent rise in the national liability limit is not clearly ruled out.

The planned CACs, which are to facilitate the participation of the private sector in crisis resolution measures, will not apply to govern-

ment bonds with a maturity of less than one year. This restriction encourages the issuance of short-term debt securities, although, according to the conclusions of the European Council last December, a greater emphasis is to be placed on paper with medium to long-term maturities. In principle, CACs should be included in all government debt instruments and not be limited to bonds. The involvement of the private sector could also be facilitated by a procedure that has yet to be developed, which would provide more detailed regulation on how to deal with government solvency problems in general.

To ensure that the participation of the private sector is as smooth as possible, it is also important that the ESM is complemented by appropriate financial market regulation that noticeably reduces the risk of systemic problems for financial market players and thereby limits as far as possible the need for governmental intervention in this sector.

More comprehensive approach for application of CACs

Appropriate financial market regulation important