DEUTSCHE BUNDESBANK
EUROSYSTEM

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The financial and sovereign debt crisis has confronted the euro area and its member states with major challenges, and has yet to be overcome. Reforms have been carried out and measures taken in many policy spheres. However, earlier calls to create a political or fiscal union and to fundamentally reform the EU treaties seem to have been silenced by the decision to set up a banking union. There appears to be insufficient political support for a significant transfer of sovereign powers from the national to the European level. As long as that remains the case, it is crucial to shape and strengthen the existing regulatory framework of monetary union over the medium to long term in such a way that it can reliably and lastingly deliver on its promise to act as a union of stability.

Despite all the coordination mechanisms in place, the euro-area member states have more or less free rein in economic and fiscal policy. Conversely, individual member states are responsible for their own debt, and both monetary financing and joint liability are prohibited. This accords with the fundamental principle that governments – and investors – should be accountable for their own actions. This implies that monetary union also has to be able to withstand the extreme scenario of a member state becoming insolvent. The original framework did not take adequate account of this aspect or, notably, its repercussions for financial stability. Although numerous reforms have been launched to combat the crisis, in many areas they have tipped the balance towards increased elements of joint liability. All in all, a number of challenges still lie ahead on the road to constructing a more cohesive framework that can better prevent future crises and, in particular, ensure that monetary policy remains focused on price stability.

This article outlines various approaches to making the European monetary union more resilient to crises in future. Strengthening financial stability is a key part of this process, and should include steps to curb the risks that sovereign solvency problems pose to particularly systemically important banks, eg by reducing the preferential regulatory treatment of sovereign exposures in the medium term and eliminating it altogether in the long term. Equally, the negative impact of bank distress on sovereigns should be minimised. To achieve this, banks' loss-absorbing capacity needs to be further strengthened. Where necessary, orderly resolution must be possible even for large, interconnected financial institutions without tapping public funds. In the area of fiscal policy, budgetary surveillance and the implementation of fiscal rules should be improved, and consideration given to an overhaul of the institutional framework. It also appears necessary to reinforce the disciplining effect of the financial markets on fiscal policy and to develop crisis management mechanisms which reduce moral hazard. Stability-oriented monetary policy crucially relies on its ability to resist pressure to step into the breach for overindebted banks or sovereigns.

Overview

Sovereign debt crisis an acid test for monetary union

The financial and sovereign debt crisis was an acid test for monetary union. At the height of the crisis, some member states lost access to the capital market, and there was speculation that some countries might exit the euro or even that monetary union itself was in jeopardy. While the situation in Greece has flared up again, the acute threats on the financial markets have receded on the whole, and the macroeconomic outlook has brightened. Nonetheless, the public finance situation in some member countries remains problematic. Just under half of the member states are still posting excessive deficits, and government debt has reached extremely high levels in some countries. At the same time, economic growth in the euro area is low. Although unemployment has been trending downwards since mid-2013, it remains very high. Structural reforms are necessary, and the private sector, which is still burdened by very substantial debt levels, needs to deleverage. The task of acute crisis management has largely been left to the central bank. Although the raft of non-standard monetary policy measures have helped to contain the crisis and its repercussions, in some areas, the central bank is now operating at the very limits of its mandate. Among other measures, the Eurosystem has launched purchase programmes which are expressly targeted at the government bonds of countries facing high risk premiums.[1] It has greatly expanded the collateral framework for monetary policy refinancing operations and taken contingency measures to provide massive liquidity.

Article focuses on proposals to stiffen monetary union's resilience to crises and better safeguard the role of monetary policy

This article first reviews the key causes of the crisis and the shortcomings it revealed in the regulatory framework underpinning European monetary union. Next, it briefly outlines the action taken in selected fields to prevent similar crises from occurring in future (see pages 15 to 37). It then looks at various complementary proposals to contain ongoing sources of risk and to fundamentally improve the monetary union's resilience to crises going forward. A key aim in this must be to allow monetary policy to focus on its mandate and its core objective of safeguarding price stability and prevent it from being misappropriated to solve problems in other policy areas. The article focuses on the need to fill in important missing links in the areas of financial stability (see pages 22 to 29), which has proved to be an Achilles' heel in the current regulatory framework, and fiscal policy, which lay at the heart of the sovereign debt crisis (see pages 29 to 34). In addition, it touches upon macroeconomic policy aspects (see pages 34 and 35) and monetary policy facets (see pages 35 and 36).

Loopholes in the original regulatory framework, and reforms launched

Pillars of the existing regulatory framework

Maastricht Treaty safeguarded stability-oriented monetary policy by giving central bank a clear mandate, extensive independence and …

The euro-area regulatory framework for monetary and economic policy, enshrined in the Maastricht Treaty in 1992, is founded on two pillars.[2] First, the Eurosystem was granted extensive independence and given a clear mandate to focus on the objective of price stability. It was concurrently forbidden to lend to government entities or to directly purchase government debt instruments (prohibition of monetary financing). These strictures were designed to prevent the objective of price stability from being subjugated to competing political interests. The rationale behind this was the insight that a clear focus on stable prices is, in the long term, the best way for monetary policy to contribute to sustainable economic growth and lasting high employment and that central bank

1 This applies to the Securities Markets Programme (SMP) and the Outright Monetary Transactions (OMTs).
2 See European Union (2010), consolidated versions of the Treaty on European Union and the Treaty on the Functioning of the European Union, Charter of Fundamental Rights, and European Commission (2015), Economic and monetary union and the euro – For stability, growth and prosperity across Europe, The European Union Explained, publication series.

independence must be legitimised by a clear and narrowly defined mandate.

… providing incentives to achieve sound public finances through …

Second, the Maastricht Treaty sought to safeguard the Eurosystem's independence not just on paper but also in practice. Thus where an imprudent fiscal policy threatens to drive a state to insolvency, even a theoretically independent central bank can come under substantial pressure to avert the high short-term economic costs of a sovereign insolvency by resorting to monetarisation. To avoid this danger, public finances should be sound enough to fully ensure the government's solvency at all times without the need for support from the central bank.

… fiscal rules and …

The intention was to safeguard sound public finances in the euro-area member states in two ways. First, budget rules were agreed – including, notably, ceilings on government deficit and debt ratios. A budgetary surveillance procedure was set up to identify and promptly correct problematic developments. Sanctions were established to penalise sustained and severe infringements of the rules. However, there are no tools at the European level for direct corrective intervention in national budgets.

… the disciplining effect of the financial markets

Second, it was hoped that market mechanisms would provide key incentives for sound fiscal policy.[3] It was thus assumed that markets would impose interest rate premiums on countries pursuing unsound public finances so as to compensate investors for increased risk, which in turn would encourage fiscal policymakers to apply fiscal discipline. Not least to allow this corrective mechanism to take effect, a "no bail-out" clause for both the member states and the monetary union as a whole was introduced alongside the prohibition of monetary financing. The fiscal framework of the Maastricht Treaty thus centres on the individual responsibility of both investors and national fiscal policies; it rules out monetary policy measures aimed at shoring up fiscal sustainability and bail-outs at the expense of the union as a whole or of other member states. These provisions are designed to ensure that policymakers also bear the consequences of their decisions (balance between liability and control). Implicitly, the possibility *in extremis* of a member state that is unwilling or unable to service its debt becoming insolvent is therefore integral to the framework of European monetary union.

Shortcomings of the original regulatory framework

Insufficient incentives for strict implementation of fiscal rules and …

This regulatory framework failed to prevent the sovereign debt crisis. Although the fiscal rules are, in principle, a suitable means of strengthening fiscal discipline, they were not rigorously implemented and enforced in the past. In addition, amendments and exemptions made the rules opaque and undermined their binding force.[4] Consequently, it was difficult for the general public to judge whether there was a valid excuse for specific infringements of the limits. Even before the financial and economic crisis erupted in 2008, member states often failed to adhere to the fiscal rules, and there was little political pressure to comply. Many countries' public finances were therefore already in fairly poor shape in the run-up to the crisis. The true problems were also obscured to some extent by inadequate statistical data. Creative accounting and, in Greece's case, prolonged, massive massaging of the official figures sometimes portrayed the public finance situation in an overly positive light.

… inadequate statistical data

Not enough attention paid to impact of macroeconomic imbalances, …

Doubts about the solvency of some governments during the debt crisis were not solely the result of unsound fiscal policy developments, however. In the first ten years of monetary union, major macroeconomic imbalances had built up in some member states. As domestic demand and unit labour costs grew relatively

3 See Committee for the Study of Economic and Monetary Union (1989), Report on economic and monetary union in the European Community.
4 For example, France and Germany blocked an escalation of their excessive deficit procedures in 2003. As a result, the rules of the Stability and Growth Pact were diluted in 2005.

strongly and some countries' real estate markets boomed, price competitiveness deteriorated substantially, dependence on capital imports rose and the factors of production became increasingly concentrated in sectors with a domestic focus. The interest rate environment encouraged a sharp rise in household and corporate debt, which was mainly funded via domestic banking systems. All in all, the sustainability of the prevailing economic situation was substantially overestimated, as were income prospects and the long-term value of many investments and assets. Public budgets initially benefited significantly from the strong domestic demand, robust wage growth and more favourable funding conditions. But the public finance situation then worsened with the onset of the crisis as huge corrections had to be made to macroeconomic imbalances, misallocations came to light and the outlook for growth deteriorated dramatically. The original assessments of the structural budget position and the available fiscal leeway thus proved *ex post* to be far too optimistic.[5]

… support measures for financial institutions, …

In a number of countries, extensive government measures to shore up financial institutions contributed to a huge deterioration in the situation and outlook of public finances. These institutions encountered financial distress in the wake of the financial and economic crisis because the high household and corporate debt they had co-financed turned out to be unsustainable. The governments concerned mostly argued that an injection of public money into these institutions and the associated conversion of private into public debt was the only way to avert a threat to the stability of the financial system.

… insufficient disciplining of fiscal policy by the financial markets, …

Overall, it was a long while before the financial markets began discriminating more strongly between sovereigns (and banks) with different credit quality profiles. Prior to the onset of the financial and economic crisis, long-term interest rates on sovereign bonds showed hardly any spread, and fiscal policymakers were undaunted by the prospect of rising risk premiums. One reason for this may have been that the markets believed from the outset that a sovereign insolvency was highly unlikely and that a European rescue operation would be launched if the situation were to deteriorate sharply. Another reason was that the markets seemingly misjudged the sustainability of macroeconomic growth and thus the underlying robustness of some countries' public finances. Once they began to reappraise individual states' public finances, however, interest rate spreads widened sharply and abruptly in some cases as the markets increasingly lost confidence in the sustainability of debt levels. Some countries failed to counter these developments rapidly and sufficiently through a radical and credible switch in their fiscal policy stance.

… and dangers posed by unsound public finances to financial stability

This left some sovereigns facing the prospect of solvency problems. In addition, large amounts of funds were withdrawn from the banking systems in a number of euro-area countries. Given substantial dangers to financial stability in the euro area, exemptions to the rules were made so as to permit bilateral financial assistance from other euro-area states, and support packages were adopted. In the face of intense pressure, the Eurosystem decided to expand its traditional toolkit by adding unconventional instruments, some of which stretched the limits of its mandate. While these measures prevented the crisis from coming to a head and took the weight off the countries receiving support, they also weakened the accountability of sovereigns and investors as well as the credibility of the no-bail-out rule. Pressure on politicians to push through more extensive institutional reform in the euro area eased off. The introduction of emergency measures, which were not envisaged when monetary union was launched, was chiefly driven by concerns that a sovereign default in the European monetary union might impair financial stability not only in

5 For more detailed information on this issue, see various articles in Deutsche Bundesbank, Monthly Report, January 2014.

the country affected but also right across the euro area. These dangers were underestimated when monetary union was set up.

Reforms implemented or initiated

Some reforms already implemented or initiated in the fields of financial market regulation, …

A raft of reforms have been put in place since the onset of the crisis to more effectively avert future crises or make them easier to manage. Measures were implemented in the fields of financial market regulation and banking supervision in an effort to eliminate the need for governments to use public money to rescue distressed banks, especially those which are potentially systemically important ("too-big-to-fail" problem). A major objective is to lessen the danger of a mutually reinforcing feedback loop between banks and public finances (sovereign-bank nexus). Measures taken to this end include a dedicated resolution regime for banks. This notably envisages bailing in shareholders and creditors to bear a portion of the losses of a resolved credit institution, thereby obviating or minimising the need for government support measures.[6] The resolution regime is complemented by rules aimed at improving banks' resilience. These chiefly comprise rules enhancing the quantity and quality of capital to be held by all banks but especially by systemically important institutions. Other reform components are designed to diminish systemic risk. For instance, macroprudential instruments such as a countercyclical capital buffer and variable capital requirements for retail and commercial real estate lending can be deployed in future to combat an accumulation of risk in the financial system.[7]

… banking supervision and bank resolution, …

In the fields of banking supervision and bank resolution the launch of the new banking union will spark major changes, not least with a view to protecting public finances from contagion from financial sector distress.[8] The Single Supervisory Mechanism (SSM) was put in place to harmonise prudential standards across all the participating member states. Amongst other things, it is hoped that this will counteract the temptation for national supervisors to give their domestic banking sector a competitive edge by regulating it lightly, whereas the resulting risks to stability could well spill over to other jurisdictions where they might have to be borne by governments. The provisions concerning bank recovery and resolution and the Single Resolution Mechanism (SRM) likewise seek to make injections of public money the exception rather than the rule in future. The envisaged liability cascade for bank resolutions is broadly similar to normal insolvency proceedings in that shareholders will be first in line to bear losses, followed by creditors. As a rule, these two groups will be fully liable for any capital shortfall remaining after the write-down and conversion of relevant capital instruments, although they are not to be worse off than under normal insolvency proceedings. If the ailing bank's shareholders and creditors cover at least 8% of the liabilities, the resolution fund can then, in isolated cases, contribute towards funding the resolution. The resolution fund's resources are divided into national compartments which will be progressively mutualised over a period of eight years. If these measures prove to be insufficient, public funds can be drawn upon as a last resort.[9] National public funds will need to be the primary source of funding until a common fiscal backstop (the design of which still needs to be agreed upon during the transitional period) is up and running. If the member state in question is unable to raise sufficient funding, it has the option of requesting assistance from the European Stability Mechanism (ESM) subject to certain conditionality. As a last

6 The key attributes of effective resolution regimes agreed at the global level were implemented in the European Union by way of the Bank Recovery and Resolution Directive (BRRD). For more information see Deutsche Bundesbank, Europe's new recovery and resolution regime for credit institutions, Monthly Report, June 2014, pp 31-55.
7 Additional buffers are in place for systemically important banks.
8 For more information see Deutsche Bundesbank, Launch of the banking union: the Single Supervisory Mechanism in Europe, Monthly Report, October 2014, pp 43-64.
9 For more information see Deutsche Bundesbank, The envisaged role of public funds in European bank resolution, Monthly Report, June 2014, pp 53-54.

resort, a facility has also been put in place to recapitalise banks directly using ESM funds, subject to strict conditionality, if the provision of further ESM assistance loans would pose a threat to the sustainability of sovereign debt.[10] Finally, the envisaged harmonisation of national deposit guarantee schemes is designed to strengthen the single market and improve depositor protection.

… budgetary surveillance, …

In the fiscal field, fiscal policymakers announced at the height of the crisis that the existing budgetary rules would be tightened as a *quid pro quo* for the granting of extensive financial support, and they adopted measures to avoid a repeat of the misguided developments that had occurred in the years preceding the crisis. Amendments to the Stability and Growth Pact (SGP) came into force at the end of 2011 which notably allowed sanctions to be imposed on euro-area countries which miss the medium-term goal of achieving a structurally close-to-balance government budget. Similarly, financial sanctions can now be imposed more quickly on member states which fail to carry out the prescribed measures to correct an excessive deficit. The 2011 legislation also introduced special majority voting requirements which make it more difficult for the Council to reject a sanction recommended by the European Commission. The Commission's role was strengthened because it was thought at that time that it would take a harder line than the Council. The amended SGP also specifies how government debt-to-GDP ratios in excess of the 60% ceiling are to be reduced, besides introducing measures that will enhance the quality of budgetary statistics. Furthermore, the 25 EU member states which adopted the Fiscal Compact have committed to enshrining in their respective national legislation uniform budgetary objectives that are largely on a par with the European requirement to achieve a structurally balanced budgetary position in the medium term.

… crisis resolution mechanism …

The European Financial Stability Facility (EFSF) and the European Financial Stability Mechanism (EFSM), which were initially set up as temporary fiscal assistance mechanisms, were superseded by the ESM. This permanent support fund can provide temporary liquidity assistance for illiquid, albeit not overindebted sovereigns in situations where it is thought that a failure to provide assistance would jeopardise financial stability in the euro area as a whole or in an individual member state. Countries requesting ESM liquidity assistance are generally required to sign up to adjustment programmes that are subject to economic and fiscal policy conditionality.[11]

… and macroeconomic surveillance

In the macroeconomic field new macroeconomic imbalance procedures (MIP) were introduced.[12] They are aimed at helping to avoid, identify and, where necessary, eliminate looming or existing macroeconomic imbalances in the member states if those imbalances might impair economic stability in the relevant member state, the euro area and the European Union (EU). Much like the SGP mechanism, financial sanctions can also be imposed under the MIP if a member state repeatedly fails to cooperate in correcting an excessive imbalance.

Many reforms heading in the right direction but more needs to be done

Many of the reforms mentioned above take on board the lessons learned from the crisis and may contribute to preventing and resolving future crises. These initiatives are likely to have fostered financial system stability, reduced the threat posed by the banking sector to national government finances and made investors more accountable for their investment decisions. The upshot of these measures, such as the introduction of fiscal support funds, the single bank resolution fund and a number of Eurosystem measures, has been to distinctly increase the

10 For more information see Deutsche Bundesbank, Implications of the banking union for financial stability, 2014 Financial Stability Review, pp 69-88.
11 The first assistance programme for Greece in spring 2010 was funded by bilateral loans granted by euro-area countries. For more information see Deutsche Bundesbank, Towards a European Stability Mechanism, Monthly Report, February 2011, pp 64-65.
12 For more information see Deutsche Bundesbank, Economic policy coordination in the European Union, 2012 Annual Report, pp 36-39.

degree of joint liability within the euro area. While European-level surveillance and coordination were stepped up at the same time, their design and implementation were and are unsatisfactory in some cases, and there is good reason to seriously doubt that the rules as they currently stand will be strictly applied.[13] In effect, member states' autonomy in economic and fiscal policy matters has been left largely intact. All in all, the reforms do not go far enough, and, with the exception of the banking union, the increase in mutualised liability has not been matched by the introduction of broader joint control mechanisms.[14] This would suggest that the euro area is inadequately protected against fresh financial turmoil and the attendant risk of monetary policy being swayed by fiscal policy.

Template for further reform

Two templates conceivable for a regulatory framework with reduced moral hazard: a decentralised approach …

Broadly speaking, two different models can serve as a template for a regulatory framework for monetary union that features reduced moral hazard. Both models should ensure that policymakers also bear responsibility for the consequences of their decisions (balancing liability and control). The first of these models follows a decentralised approach and is rooted in the Maastricht Treaty. Apart from the single monetary policy, it is premised on extensive national accountability of member states. While it is true that European rules can encroach on this autonomy (in fiscal matters, for example), the European level ultimately has no power to intervene directly in national affairs. The notion of leaving decision-making powers largely at the nation-state level is consistent with the no-bail-out rule (which lays down that a member state's debts cannot be assumed by other member states or the community) and the possibility of a member state defaulting.[15]

… and a fiscal union that mutualises risk and transfers budgetary sovereignty

The other template centres on the idea of economic and fiscal policy integration – in effect, fiscal or political union. This approach maintains a balance of liability and control by matching the increased mutualisation of risk with a surrender of (at least fiscal) sovereignty to a central European level.[16] Calls to move forward in this direction came from various quarters at the height of the crisis.[17] A cohesive fiscal or political union backed by a large political majority across all countries and sharing a common economic policy vision – a federation of states – would certainly be less vulnerable to crises overall than a currency union composed of autonomous member states if the latter does not appear capable of withstanding the insolvency of individual states. However, following the decision to set up a banking union, the politicians seem to have lost any interest in ramping up the pace of integration or embracing fundamental treaty change, apparently because they do not believe that such steps, and especially the extensive surrender of national sovereignty, will enjoy majority backing in the member states.

Spotlight on strengthening the decentralised model

As long as that remains the case, the focus of future reforms will need to be on improving the resilience of the existing framework, but there

13 See, for example, Deutsche Bundesbank, Fiscal developments in the euro area, Monthly Report, May 2014, pp 68-72; and Deutsche Bundesbank, The implementation of fiscal rules in the European monetary union, Monthly Report, December 2014, pp 8-10.
14 See, for example, German Institute for Economic Research, Zukunft der Währungsunion, DIW Wochenbericht 24/2014, pp 527 ff; Deutsche Bundesbank, European Council decisions on the prevention and resolution of future sovereign debt crises, Monthly Report, April 2011, pp 53-58; Deutsche Bundesbank, Banking union: a useful addition for Europe in the medium term, 2012 Financial Stability Review, pp 82-83; Deutsche Bundesbank, Implications of the banking union for financial stability, 2014 Financial Stability Review, pp 69-88.
15 For further background information on this article, see German Council of Economic Experts, Stabile Architektur für Europa – Handlungsbedarf im Inland, 2012/13 Annual Economic Report, pp 102 ff; and Gegen eine Rückwärtsgewandte Wirtschaftspolitik, 2013/14 Annual Economic Report, pp 156 ff.
16 See also A Sapir and G Wolff, Euro-area governance: What to reform and how to do it, Bruegel policy brief, 2015/01. Effective control of joint liability instruments would be impossible without first surrendering the relevant decision-making competence. See expert group on a debt redemption fund and eurobills, final report, 31 March 2014.
17 See H van Rompuy, J Barroso, J-C Juncker and M Draghi, Towards a genuine economic and monetary union, Report to the European Council, December 2012.

is no getting round the fact that rules can only ever fulfil their purpose if they are rigorously applied in practice. Bearing this in mind, the following sections outline approaches that seek to strengthen the existing regulatory framework based on national accountability. The guiding principles of this framework are enshrined in the European treaties and as such constitute the foundations of European monetary union. Specifically, these are the no-bail-out clause, extensive economic and financial autonomy of the member states, their citizens and investors, and the *de jure* and *de facto* independence of monetary policymakers in pursuing their primary objective of ensuring monetary stability. The sections below consider at length key steps towards better safeguarding financial stability (see pages 22 to 29) and ensuring sound public finances (see pages 29 to 34) before briefly discussing options for improving macroeconomic coordination and the role of monetary policy (see the summary on page 23).

Steps towards safeguarding financial stability

Safeguarding financial stability key to curbing threat of monetary policy coming under pressure

Sound public finances in the member states and a path of macroeconomic development that is devoid of serious and persistent imbalances are important prerequisites for safeguarding financial stability in the euro area. However, extensive safeguarding of financial stability requires that it remains robust even if individual member states fail to prevent the emergence of macroeconomic imbalances or to rein in ballooning sovereign debt that might leave that country teetering on the brink of default. This objective primarily targets the banking system, given its particular systemic importance for the stability of the financial system. But other potentially systemically important areas of the financial system, such as the shadow banking system, need to be addressed as well.[18] Regulators and supervisors play a pivotal role in the prevention of systemic crises in the financial sector. Yet if financial institutions nonetheless encounter stress, the onus is on monetary policymakers to step in with temporary liquidity assistance for banks that are illiquid but not overindebted. The task of the resolution authority and, at the end of the day, fiscal policymakers, by contrast, is to either recapitalise overindebted financial institutions by bailing in their shareholders and creditors, or to wind them up in an orderly fashion where a failure to do so would jeopardise the stability of the financial system. Part of the rationale for this is that this task involves large-scale decisions affecting the redistribution of funds and debts. If fiscal policymakers fail to fulfil this task, monetary policymakers may come under pressure to step into the breach.

Sovereign-bank contagion nexus must be effectively severed in both directions

Two objectives need to be achieved in order to stem the spillover of risk from the government to the banking sector and *vice versa*. First, financial stability needs to be maintained even in the unlikely yet conceivable worst-case scenario of a haircut being imposed on sovereign bonds. Shoring up financial stability in this way is crucial for upholding the principle of national responsibility and the no-bail-out clause. Second, the risk of contagion channelling in the other direction – from banks to sovereigns – likewise needs to be effectively curbed.

Reducing the risk of contagion from the banking sector to the government sector

Banks' loss-absorbing capacity is key to stopping spillover of risk from banking to government sector

The bulk of the measures rolled out so far to safeguard financial stability address the spillover of risk from banks to sovereigns. Although some progress has been made, further action still needs to be taken. To further reduce the risk of contagion, it needs to be ensured that systemically important banks, in particular,

18 The shadow banking system can in general be defined as credit intermediation involving entities and activities outside the regular banking system. See Financial Stability Board, Shadow Banking: Strengthening Oversight and Regulation, Recommendations of the Financial Stability Board, Report, October 2011, p 1.

Summary of selected recommendations and measures

<table>
<tr><th>Financial stability</th><th>Fiscal policy</th><th>Economic policy</th></tr>
<tr>
<td>Strengthen banks' loss absorbency: capital requirements and/or leverage ratio

Consistently deploy and refine macro-prudential toolkit

Improve integration of equity and debt markets
– Uniform legal framework
– Diversified lending

Segregate monetary policy and banking supervision

Single Resolution Mechanism (SRM)
– Adequate bail-in-able capital
– Apply bail-in rules strictly, and stringently wind down non-viable banks
– Common fiscal backstop with national loss retention

Properly regulate financial system outside the banking sector (eg shadow banks), too</td>
<td>Set up independent budgetary surveillance institution

Fiscal regime
– Simpler and clearer rules, strictly applied
– Uniform and transparent surveillance
– Reduce discretionary leeway
– Step up automatic corrective measures
– Strengthen role of debt ratio

ESM
– Conditional liquidity assistance
– Interest rate mark-ups for assistance
– Stronger role in insolvency process
– Non-standard fiscal measures to avert or mitigate haircuts</td>
<td rowspan="2">Review imbalance procedure and adapt if necessary once sufficient experience has been gathered; implement strictly

Streamline and enhance transparency of European coordination mechanisms

Take account of cross-border effects, but no fine-tuning of economic policy by central authority</td>
</tr>
<tr>
<td colspan="2">Deprivilege sovereign bonds
– Capital backing
– Large exposure limits
– Adapt liquidity rules

Revise sovereign bond contracts
– Collective action clauses with single-limb aggregation
– Automatic maturity extension if ESM assistance granted

Create framework for more orderly sovereign insolvency</td>
</tr>
<tr><th colspan="3">Monetary policy</th></tr>
<tr>
<td colspan="2">Keep focus on core objective of price stability

Define mandate narrowly so as to legitimise independence

Do not undermine unity of liability and control in other areas or distort market processes</td>
<td>Assume no responsibility for financial stability risks caused by sovereigns' and banks' solvency problems

Avoid engineering joint liability for sovereign solvency risks via central banks' balance sheets

Institutional segregation of monetary policy and banking supervision</td>
</tr>
</table>

Deutsche Bundesbank

have deep loss-absorbing capacity. This increases, for example, with higher capital, which absorbs losses and thus allows business operations to be continued. Some critics claim that stricter capital adequacy requirements drive up banks' funding costs and might, as a result, stunt macroeconomic growth.[19] As a rule, however, any higher funding costs are matched by macroeconomic benefits stemming from the potential improvement in financial stability. However, where higher funding costs result from the fact that tighter capital requirements eliminate or reduce implicit government guarantees, this is no reason not to impose stricter capital standards. At the end of the day, this merely removes an inappropriate subsidisation of banks' debt financing.

19 This line of argument is open to doubt, however. The Modigliani-Miller theorem, for instance, holds that, given perfect markets, an enterprise's funding costs are unrelated to its form of funding. A rising equity capital ratio lowers the uncertainty of payment flows for shareholders and creditors alike, thus reducing the risk premium for both forms of funding. This offsets the additional cost involved in holding a higher proportion of (more expensive) equity capital. While it is true that market frictions, an asymmetric distribution of information or taxes may well drive up the cost of equity, empirical research suggests that the additional costs are not substantial. See also European Central Bank (2011), Common equity capital, banks' riskiness and required return on equity, Financial Stability Review, pp 125-131.

Capital requirements should be critically reviewed

In order to increase banks' loss-absorbing capacity, the new capital requirements under Basel III should be critically reviewed.[20] Such a review should notably examine whether the risks that are not captured or are insufficiently captured in the risk models are adequately backed by capital (eg by the various capital buffers). It is not least in the light of such risks that the risk-weighted capital requirements were supplemented by the introduction of an instrument that is explicitly not risk-based, ie the leverage ratio. From 2018, it will be possible to convert this ratio from a monitoring metric to a binding measure. In this case, too, it should be reviewed whether the minimum requirement of 3% currently being tested by the Basel Committee is appropriate.

Macroprudential monitoring plays a supporting role, but is not a panacea

Macroprudential monitoring and policy play a part in making the financial system more resilient and also in adequately curbing cyclical developments of systemic risk. The instruments created for this at the European and national levels at least for the banking sector, such as the countercyclical capital buffer, the systemic risk buffer, and the option of higher risk weights for certain exposures, are essentially suitable for countering undesirable developments in a relatively focused way. The effectiveness of macroprudential policy will, however, hinge on how willing policymakers actually are to rigorously deploy the instruments and to tackle unwelcome developments, including in the face of political pressure if necessary, and on the extent to which any evasive actions can be thwarted. It would be wrong to place exaggerated expectations on macroprudential policy. It has only a limited ability to counter misguided developments originating from risky national economic or fiscal policy, as it cannot tackle the root causes. Tax legislation in many member states, for example, currently favours debt financing over equity financing. This tends *per se* to weaken firms' capital base, which means that bank loans can more quickly become non-performing in the event of negative shocks. In turn, this weakens the stability of the financial system. While, in this regard, macroprudential policy can strengthen the resilience of the banking sector and damp the cyclical dynamics of the financial system, the tax policy bias remains in place. The existence of macroprudential instruments therefore cannot be used as an argument for laxer regulation in other areas or for less prudent economic policy. This constraint is further underscored by the fact that the macroprudential instruments that are currently available predominantly seek to contain undesirable developments that originate in the banking sector. The task of extending the macroprudential toolkit to other areas such as the insurance sector or the shadow banking system is still in the early stages.

Positive effects could also emanate from a capital markets union and …

The concept of a capital markets union is currently being debated as a way of advancing integration of the debt markets and, above all, the equity markets. Dismantling the barriers and restrictions related to this can play a role here. This could allow the impact of asymmetric shocks to be more widely spread and better cushioned within the EU via the financial markets. The desired stronger diversification between capital market-based and bank-based financing would have a similar effect.

… more diversified bank lending

In addition, more diversified bank lending in the euro area would disperse risk more widely and thus strengthen the banking sector with regard to problems confined to individual member states. Domestic banks, for example, would be less affected by the consequences of misguided fiscal policy developments in a country extending to the extreme risk of a haircut on government debt which, moreover, would normally be accompanied by a recession and a rising wave of credit defaults in that country. However, the prerequisite for this is that credit risk does not rise on account of diversification.

20 The requirements envisage a basic capital ratio of at least 8% of risk-weighted assets. Additionally, however, banks will need in future to hold various capital buffers on top of the minimum requirements in order to reduce the risk of the minimum capital requirements being undershot. Capital surcharges for systemically important financial institutions will also be introduced.

Independent and stringent banking supervision another central pillar

Comprehensively securing financial stability requires independent and stringent banking supervision. Conferring responsibility for banking supervision on a Single Supervisory Mechanism (SSM) was a first key step.[21] In order to avoid conflicts of interest with monetary policy, however, in the longer term banking supervision should not be based at the ECB but instead at an independent institution that has the final say in supervisory matters, or at the very least, the decision-making structures for monetary policy at the ECB should be clearly separated from those for banking supervision. Against this backdrop, plans should be made to amend European primary law.

Quicker market exit of insolvent banks and entry of new banks

A country's economic recovery can also be speeded up by making it easier for insolvent banks to exit the market and for new banks to enter the market. Uniform and accelerated insolvency proceedings throughout Europe for households and enterprises could reduce uncertainties by facilitating faster identification of banks' actual balance sheet position.

SRM needs adjusting to ensure efficient bank resolutions

Some adjustment is required to the Single Resolution Mechanism (SRM), which is designed to facilitate the orderly resolution also of systemically important financial institutions without recourse to government support measures. Given the extremely complex decision-making framework, there is considerable doubt as to whether bank resolutions can be carried out efficiently in the tight timeframe envisaged.[22] This points to a continuing need to amend primary European law with a view to creating the legal basis for a genuine European resolution authority with efficient autonomous decision-making powers.

Need for government support measures for banks should be minimised through rigorous implementation and …

There is still a considerable need for improvement to ensure that the risk of bank insolvencies is actually borne by the investors and to effectively reduce the probability and extent of future strains on public budgets from the financial sector. What is particularly problematic is that applying the bail-in tool to creditors involves great discretionary scope. On top of this, it is uncertain how far the political announcement that the banking sector will be called on to finance losses where necessary, possibly by way of *ex post* levies, will be followed up. In order to reliably ease the burden on public budgets and to ensure that investors increasingly bear risks themselves, there are a number of conceivable approaches besides the higher capital ratios already discussed. For instance, in the actual implementation of resolutions it is crucial that banks which are a gone concern really are rigorously resolved without using taxpayers' money. This will allow a track record to be established that negates the lingering expectation of an implicit government guarantee.

… sufficient bail-in-able debt

In addition, the bail-in of creditors could be made more credible *ex ante* by obligating banks to hold sufficient capital and debt that is reliably available for bail-in in a loss event.[23] This is the objective of the minimum requirements for loss-absorbing capacity – or total loss-absorbing capacity (TLAC) – which the Financial Stability Board (FSB) is aiming to introduce for global systemically important financial institutions; these requirements are intended to make sure that there are sufficient levels of liable capital and debt in a resolution event. For this to succeed, however, it must be ensured that the draft presented by the FSB in November 2014 is not watered down in the ongoing

21 For more information, see Deutsche Bundesbank, Launch of the banking union: the Single Supervisory Mechanism in Europe, Monthly Report, October 2014, pp 43-64.

22 For more information, see Deutsche Bundesbank, Europe's new recovery and resolution regime for credit institutions, Monthly Report, June 2014, pp 31-55.

23 The Expert Advisory Committee to the Federal Ministry of Finance has put forward a proposal on this. According to this proposal, a significant requirement of bail-in-able capital would be that it may not be held by banks either directly or indirectly (eg via credit default swaps (CDSs)), in order to avoid the risk of contagion across the banking system. Furthermore, a clear trigger for a liability event should be defined in bond contracts, and debt should then automatically be converted into equity (comparable to "coco bonds"). Finally, it would have to be ensured that other debt positions are not automatically exempted from bail-in owing to the existence of these bail-in bonds. See Expert Advisory Committee to the Federal Ministry of Finance, Stellungnahme zur aktuellen Entwicklung der Europäischen Bankenunion – Plädoyer für ein glaubwürdiges Bail-in, 01/2014.

consultation process.[24] Furthermore, regulatory requirements must restrict other banks from holding TLAC instruments in order to avoid contagion effects. The Bank Resolution and Recovery Directive (BRRD) also contains minimum requirements for liable equity and debt, in the form of minimum requirements for own funds and eligible liabilities (MREL).[25] For this element of liability to be credible *ex ante* in a resolution event, however, it would have to be assured that, as well as own funds, the liabilities covered by the minimum requirements, in particular, can actually be drawn on in the event of a resolution. Potential contagion channels in the financial system would have to be closed as far as possible. At the same time, the discretionary scope for decision-making in a resolution event would need to be more clearly limited.

Common fiscal backstop that minimises moral hazard

The additions to the safeguards that have already been implemented at the upstream stages discussed in this article are intended to rule out government support measures if possible. Nonetheless, a credible fiscal backstop may be required as the final step of the liability cascade to enable orderly resolutions also of systemically important financial institutions, if necessary, and to avoid excessive uncertainty in the markets. This would prevent central banks from being pressured to keep failed banks alive by providing extensive and sustained liquidity and thus avoid resolutions entailing considerable risk to financial stability. To align liability and control in the field of banking supervision, it would essentially be conceivable, following the transfer of banking supervision from the national to the European level, to likewise put in place a fiscal backstop at the European level. However, a prerequisite for this is that the legacy risks on banks' balance sheets that accrued under national responsibility are comprehensively rectified first. What is more, the backstop would have to be structured in a way that avoids moral hazard that would discourage sound public finances and a sustainable economic policy. The influence of national economic and fiscal policy on risks in the national banking system grows inversely to banks' degree of diversification across national borders. A risky economic and fiscal policy would tend to be fostered if the attendant risks were fully communitised, whereas temporary advantages arise chiefly at the national level. Depending on the perceived severity of these moral hazard problems and the assessment of the effectiveness of the corrective action through diversification, bail-in, the European budget and economic surveillance procedures and macroprudential policy, a more or less extensive degree of national loss retention for the costs of resolving a bank supervised at the European level would make sense.[26]

Shadow banking sector must not become a new source of systemic risk

A final requirement for comprehensively securing financial stability is that no systemic risk builds up in other areas of the financial market, for example in what is known as the shadow banking sector. Specifically, macroprudential instruments should be developed – in a similar way as for the banking sector – with respect to the improvement and further harmonisation of the framework conditions for decentralised structures in the financial system (eg for non-bank-based direct and indirect corporate financing), which is currently another objective of the capital markets union, in order to counteract any undesirable developments resulting therefrom.

Reducing the risk of contagion from the government sector to the banking sector

Equally as important as reforms relating to spillover risk from banks and the financial system to the government sector are reforms concerning

24 See Financial Stability Board, Adequacy of Loss-Absorbing Capacity of Global Systemically Important Banks in Resolution, Consultative Document, November 2014.
25 For more information, see Deutsche Bundesbank, Europe's new recovery and resolution regime for credit institutions, Monthly Report, June 2014, pp 31-55.
26 For more information, see Deutsche Bundesbank, The envisaged role of public funds in European bank resolution, Monthly Report, June 2014, pp 53-54.

Eliminating spillover risk from the government to the financial sector also in the event of sovereign insolvency

contagion risk in the opposite direction – ie from the government sector to banks and the financial system. These reforms should aim to make financial stability more independent of the development of public finances and highly likely to remain robust even in the scenario of a restructuring of government liabilities. This would also ease the pressure on monetary policy to take on responsibility for ensuring financial stability or sovereign debt sustainability. A core approach to tackling this issue likewise encompasses banking and financial market regulation. The objective of any changes must be to limit banks' sovereign exposure risk to such an extent that even strongly interconnected, systemically important banks can either absorb fiscal stress events up to and including a comparatively extensive haircut on government debt or else ensure that they can be resolved in an orderly manner if necessary. It is important in this context to take account of second-round effects that arise because a sovereign default is usually accompanied by a slump in economic activity and a growing number of non-performing loans to private debtors in the country concerned.

Approaches to limiting banks' sovereign exposure risk

Approaches to limiting the risk posed to the banking system by sovereign exposures include risk-appropriate capital backing for government bonds, a limit on the volume of sovereign exposures held by a bank (large exposure limits) and treatment of such assets under the liquidity regulation that is commensurate with their actual degree of liquidity. A great deal could be achieved here simply by ending, or at least substantially scaling back, the regulatory exemptions thus far afforded to sovereign debt from capital adequacy requirements and large exposure limits.[27] At present, capital essentially does not have to be held against banks' exposures to sovereigns in national currency, even though the sovereign debt crisis has clearly demonstrated that sovereign debt is by no means risk-free. Sovereign exposures have so far broadly been exempted from the existing large exposure limits, too. The large exposure rules are designed to prevent concentration risk in the banking system, with the aim being to stop a bank from running into difficulties itself when a debtor defaults.[28]

Changing contractual terms of government bonds also worth considering

The consequences for banks of a haircut on government debt could possibly be further reduced by changing the contractual terms of sovereign debt instruments. The aim would be to create a sufficient volume of national bonds with relatively good credit quality for banks even in times of stress, and, if possible, to transfer the default risk more from bank balance sheets to other areas of the financial market where any losses from a haircut will not lead to a systemic financial crisis. One option worth examining is the potential benefit of dividing individual national government bonds into first-loss and second-loss tranches as a complement to the amendment of banking regulations discussed above.[29]

Approaches to improving sovereign insolvency procedure can strengthen financial stability somewhat

Alongside banking regulation, a contribution to financial stability can also be made by approaches that, faced with the potential sovereign default of a euro-area state, envisage the timely initiation, rapid execution and predictable structuring of a relevant insolvency procedure. Without such mechanisms, there are incentives for both the debtor country and its creditors to postpone a sovereign debt haircut. The government of the debtor country fears a loss of votes and image as well as negative repercussions for the domestic financial system. Creditors of short-dated claims can currently press for the haircut to be delayed long enough

27 The Basel Committee has already begun reviewing the privileged treatment of sovereign exposures in the regulatory requirements.
28 For more information, see Deutsche Bundesbank, Reducing the privileged regulatory treatment of sovereign exposures, 2014 Annual Report, pp 23-40.
29 Mandatory risk diversification by bundling the bonds of all euro-area states into a single bond, as suggested by the Euro-nomics group, does not appear necessary for this. See Euro-nomics group, European safe bonds (ESBies), mimeo, 30 September 2011. Rather, the Euro-nomics group's proposal involves some joint liability elements, which run counter to the guiding principle of the regulatory framework of European monetary union. Appropriate risk diversification can be better achieved through appropriate banking regulation, as outlined above.

that their claims are satisfied in full.[30] This makes it more difficult to rapidly restore sovereign solvency, prolongs uncertainty in the financial markets about the pending steps and increases the economic costs of a sovereign debt overhang via the knock-on effects on the real economy.[31] Reform approaches to mitigating the negative impact of sovereign insolvencies on the stability of the financial system should therefore be aimed at the timely triggering of sovereign insolvency and at putting in place a reliable, efficient and transparent procedure for rapidly restoring sovereign solvency.[32] Overall, however, it must be ensured that contract fulfilment and legal principles are upheld and that countries are in no way enabled to extricate themselves too easily from contractual arrangements with regard to sovereign debt.

CACs introduced in 2013 could be stiffened

Since 1 January 2013, all government bonds issued by euro-area states with a maturity of more than one year have had to contain collective action clauses (CACs).[33] These aim to ensure efficient restructuring of outstanding liabilities if the need arises by making it easier to make changes to the key terms and conditions of a bond series that are binding for all creditors. To this end, the clause stipulates that the majority required to modify the terms and conditions for the individual bond series falls if a qualified majority across all bond series votes for a modification. This reduces any incentive for investors to hold out for full settlement of their claims at the cost of the entire group of creditors (holdout problem). However, this "two-limb" procedure cannot prevent a financially strong investor from blocking the restructuring of an individual bond series by acquiring a blocking minority. In the longer term, a solution to this could be a "single-limb" aggregated voting procedure, whereby a qualified majority across all government bonds issued is sufficient to trigger a binding debt restructuring for all bonds regardless of the voting results for individual bond series.[34]

In order to deter holdouts more effectively, the standardised bond contracts of euro-area states could additionally be critically reviewed with a view to restricting the *pari passu* clause.[35] In principle, this clause is designed to ensure the equal treatment of bondholders by issuers.[36] At the very least, however, existing ambiguities of interpretation should be eliminated so that

Modified pari passu clause would mitigate holdout problem

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30 Creditors of short-dated claims who have a blocking minority could, for instance, credibly signal that they do not consent to a potential debt restructuring.

31 The current debate about a haircut in Greece is taking place against a fundamentally different backdrop. Private creditors in Greece have already incurred a haircut, and the vast bulk of Greek debt now comprises assistance loans from public creditors. Although Greece's debt ratio is still exceedingly high, extensive debt relief was provided by the very low interest rate charged on the assistance loans (from an economic perspective, granting very low interest rates and forgoing redemption payments for a protracted period are very similar to partial debt forgiveness). The sustainability of Greek public finances is therefore significantly less strained than the debt ratio alone suggests thanks to this very limited interest burden. According to the European Commission's latest forecast, Greek interest expenditure in relation to gross domestic product in the current year, for instance, is below that of Ireland, Italy and Portugal, even though Greece's debt ratio is significantly higher.

32 See, for example, the Expert Advisory Committee to the Federal Ministry of Economics and Technology (2011), Überschuldung und Staatsinsolvenz in der Europäischen Union, Gutachten Nr. 01/11; Committee on International Economic Policy and Reform, Revisiting Sovereign Bankruptcy, Discussion Paper, October 2013; and C Fuest et al, Die Krise im Euroraum nachhaltig überwinden, Study by the Centre for European Economic Research (ZEW) for Vereinigung der Bayerischen Wirtschaft (vbw), April 2014.

33 See EFC Sub-Committee on EU Sovereign Debt Markets, Collective Action Clause Explanatory Note, 26 July 2011, and Model Collective Action Clause Supplemental Explanatory Note, 26 March 2012. The integration of CACs into the bond terms and conditions of regional and local government entities of member states is not mandatory, however.

34 See International Monetary Fund, Strengthening the Contractual Framework to Address Collective Action Problems in Sovereign Debt Restructuring, IMF Policy Paper, 2 September 2014.

35 In the global context, the IMF has attempted to strengthen contract-based debt restructurings by tabling not only proposals for model clauses with the option of a single-limb majority requirement, but also proposals for redesigning the pari passu clause, and has recommended their use in future international bond issues. See International Monetary Fund, loc cit. The IMF proposals are based on the model clauses, revised shortly beforehand, issued by the International Capital Markets Association (ICMA). See ICMA, Standard Aggregated Collective Action Clauses ("CACs") for the Terms and Conditions of Sovereign Notes, August 2014, and ICMA, Standard Pari Passu Provision for the Terms and Conditions of Sovereign Notes, August 2014.

36 It has only limited significance for sovereign issues as the concept of rank presupposes the option of liquidating the issuer's assets (and the subsequent distribution of the insufficient proceeds to the creditors). The liquidation of an insolvent sovereign's assets is hard to reconcile with the modern concept of a sovereign state and the inalienability of its sovereign rights, however.

creditors who reject a debt restructuring (holdout creditors) cannot invoke the *pari passu* clause to build up potential pressure by threatening to block payments to the restructured bonds. This reduces the holdout incentive for creditors and hence reinforces the incentive for all creditors to agree to a restructuring. As a result, the risk of a disorderly sovereign default diminishes.[37]

Regulated insolvency procedure for euro-area states could further reduce adverse effects on financial stability

In addition, a framework and procedure could be developed in the longer term which would allow government bonds to be restructured in a more orderly and structured way than is currently the case.[38] This could curb uncertainty about the steps required to restore sovereign solvency and mitigate systemic contagion effects and negative repercussions for financial stability. Any liquidity restrictions for the debt instruments that are to be restructured, the impact on the domestic real economy and the level of the debt haircut required could potentially be limited further. Regardless of such a framework, however, it must be ensured that financial stability is safeguarded to the greatest extent possible also in the not inconceivable event of a disorderly sovereign insolvency.

ESM could be given prominent role in insolvency procedure

In connection with a potentially more orderly framework for sovereign insolvencies, the ESM could be given a greater role, and could contribute to balancing the interests of debtors and private creditors as well as to achieving speedier agreement on restructuring. Sovereign debtors may in any case apply for liquidity assistance from the ESM, subject to certain conditions, until they regain access to the capital market. The prospect of such liquidity assistance is likely to make it easier for the debtor country to agree to a restructuring. Creditors will probably submit to a haircut more readily if ESM assistance is credibly pegged to structural reforms and fiscal consolidation, thus giving them greater assurance that their remaining claims will then actually be settled.

Approaches to anchoring a stability-oriented fiscal policy

Increase incentives for sound fiscal policy

Under the existing regulatory framework of the European monetary union, responsibility for fiscal policy lies mainly with the member states. They decide on the specific design of fiscal policy and also on whether the national government debt is ultimately serviced. This wide-ranging autonomy in decision-making is essentially consistent with the no-bailout principle. A central aim of stability-focused reforms in the field of fiscal policy must be to increase the incentives to pursue sound public finances.

Improve budgetary surveillance and implementation of fiscal rules

Independent European fiscal authority could aid better implementation of rules

With regard to the fiscal rules, the main problem is not so much that they are fundamentally unsuitable, but more that they are seldom designed and implemented systematically. This is illustrated, for example, by the European Commission's recent decisions to make greater use of the flexibility of the rules in future to further relax the requirements and also to loosen the requirements for sovereigns that clearly did not comply with the European Council's recommendations. At present, the Commission has a crucial role in monitoring budget developments and interpreting the European fiscal rules. Despite its formal independence, however, it faces considerable political pressure and also pursues many different objectives simultaneously. A new European fiscal authority, which, similarly to the autonomous national fiscal councils, has

37 Holdout incentives could also be effectively curbed without modifying the pari passu clause if the payment streams of the parties taking part in a restructuring are immunised against the claims of creditors that have elected not to participate in the restructuring. See Committee on International Economic Policy and Reform, loc cit. Another change to the terms and conditions of government bonds is proposed below (see pp 30 and 31) with the automatic extension of the maturity when ESM assistance is granted.
38 See, for example, F Gianviti et al (2010), A European mechanism for sovereign debt crisis resolution: a proposal, Bruegel Blueprint Series, Volume 10.

a clear mandate obligating it to solely assess budgetary developments in terms of compliance with the fiscal rules should be better able to ensure objective monitoring as well as to conduct transparent and comprehensible analysis. The new body could take over the Commission's role in the procedure and would be less exposed to the risk of making inappropriate compromises at the expense of budgetary discipline.

Simple and transparent rules create reliability and promote effective budgetary surveillance

Regardless of this institutional issue, the fiscal rules can be made more effective by making them much simpler and clearer. This would allow both the general public as well as the political opposition in the respective countries to clearly identify any breaches of the rules. This aspect is a key condition for the rules to have stronger binding force, as such public accountability ensures that the rules have a disciplining effect on the political decision-makers. It would also be necessary to make all data publicly accessible, to largely eliminate the discretionary scope laid down in the existing rules for setting fiscal targets and assessing compliance with them, and to tightly restrict and clearly define exemptions from the rules. Since responsibility for ensuring sound public finances remains with the member states, it appears advisable to restrict any European-level requirements more than before to the anticipated consolidation requirement and the deadlines for its implementation. The fundamental aim of the envisaged overhaul of the rules should not be to try and take account of every conceivable specificity by structuring the rules even more granularly, but instead to emphasise clear upper limits and thus strengthen the ability to implement the rules. Ultimately, the crucial assessment gauge should not be the (supposed) efforts of a member state, but rather the outcome. In this context, there must be a degree of acceptance that the rules cannot completely cover every single eventuality and that not all unexpected developments will be excused. What must be borne in mind is that the fiscal rules constitute agreed upper limits and that member states actually have extensive room for manoeuvre as long as the rules are complied with.[39]

Automatic correction mechanisms worth considering

Safeguarding sustainability by means of simple and transparent fiscal rules could be further reinforced by setting the scope of consolidation in the event of missed targets in such a way that not only is the deficit corrected, but the increased debt incurred in the meantime on account of the deviation is also reversed. The binding force of the European budgetary rules could also be decisively enhanced if member states, in advance of any breaches, define concrete measures that will then enter into force more or less automatically and can be replaced, at most, by fully specified, offsetting measures.[40]

Promote incentives for financial markets to press for sound fiscal policy

Disciplining effect of financial markets key incentive for sustainable fiscal policy

The actual or potential imposition of interest rate premiums on countries pursuing unsound public finances remains an important incentive for sustainable national fiscal policies in the euro area. This requires that creditors really are exposed to the full risk of any investment in government debt instruments and that they assess this risk appropriately.[41] Corresponding interest rate signals will then encourage governments to adopt a sustainable fiscal policy.

39 For more information, see Deutsche Bundesbank, Fiscal developments in the euro area, Monthly Report, May 2014, pp 68-72.

40 Sustainably safeguarding stable public finances could also be achieved by introducing direct (tiered) rights of intervention at the European level in cases of severe and persistent breaches of the fiscal rules. These could also take the form of surcharges on common taxation instruments or deductions from certain spending categories, which are to be stipulated by the member states in advance and the amount of which will vary depending on the size of the breach. However, such rights of intervention imply a distinct reduction in national fiscal sovereignty (and hence an approach that is not discussed further in this article) and is highly unlikely to find a consensus at this point in time.

41 The prerequisites for adequately assessing the risks of an investment in government debt instruments include reliable statistics, the timely provision of relevant information, and transparent processes and methodology in the context of budgetary surveillance.

However, if financial market participants expect fiscal or monetary rescue measures in the event of a crisis, this diminishes the perceived default risk of a misguided national fiscal policy, and market participants will, at best, require only small country-specific risk premiums. This weakens the disciplining effect of the financial markets from the outset.

Restoration of no-bail-out principle and compliance with the prohibition on monetary financing

Against this background, it is important that the principle of individual responsibility on the part of investors and member states is firmly re-established in future. There must be no prospect that the no-bail-out principle or the prohibition of monetary financing by central banks may ultimately be ignored. A key prerequisite for this, however, is that risks to financial stability posed by a threatening sovereign insolvency are adequately contained by the aforementioned reforms (see pages 22 to 29), as the fear of a financial market collapse is ultimately what led to these principles being relaxed during the financial crisis.[42]

Orderly sovereign insolvency procedure for euro-area countries improves credibility of the no-bail-out principle and strengthens investor liability

The collective action clauses introduced for euro-area countries in 2013 can not only contribute to greater financial stability, as explained, but are also a first important signal that investors will face a sovereign debt haircut if a country becomes overindebted. This signal could be underscored by proposals, already mentioned in the context of strengthening financial stability, to reform the contractual terms of government bonds and introduce a more orderly insolvency regime for euro-area states. This could also bolster the credibility of a debt haircut as it would mitigate the implications for the financial system and the losses for the real economy, thus making the haircut easier to push through politically. At the same time, it must be ensured that the insolvency of a debtor state is not seen as an easy option. The imposition of conditions on economic and fiscal policy by a coordinating body, such as the ESM, could prove useful in this regard, as explained below.

Automatic extension of government bond maturity if ESM assistance granted

Inserting a clause into government bond contracts that automatically extends the bond's maturity if ESM assistance is granted could also be a useful addition. This would be an effective means of preventing private creditors from receiving full repayment of short-dated bonds at the expense of providers of public assistance. Moreover, private investors would be aware that they would be involved in any subsequent haircut. Their risk would rise accordingly, which would probably help to strengthen the disciplining effect of financial markets on fiscal policy.[43]

Eliminating preferential treatment of government bonds in banking regulation would promote risk-based interest rates

The aforementioned amendments to banking regulation – risk-based backing also of government bonds, adjustments in categorising assets under liquidity rules and inclusion of public-sector bonds in large exposure rules – should additionally help to reinforce the disciplining effect of financial markets on fiscal policy. Eliminating the existing preferential capital treatment of government debt instruments would curb banks' demand for sovereign debt instruments, particularly from countries with poorer creditworthiness.[44] Overall, the measures should increase risk spreads for government bonds that have a higher probability of default and therefore make it less attractive for these countries to expand their borrowing. This would increase their incentive to pursue stability-oriented fiscal and economic policies as a declining debt ratio would hold out the prom-

42 Even if monetary policy generally has a certain role to play in safeguarding financial stability, it is limited by the prohibition of monetary financing, which places sovereign solvency protection beyond the scope of its mandate. Moreover, in a conflict of interests, the objective of maintaining price stability takes precedence over seeking to contribute to financial stability. For more information see Deutsche Bundesbank, The importance of macroprudential policy for monetary policy, Monthly Report, March 2015, pp. 39-71.
43 For more information see Deutsche Bundesbank, Proposal for an effective private sector involvement for bond issues from mid-2013 onwards, Monthly Report, August 2011, pp. 68-71 and Bank of England, Sovereign default and state-contingent debt, Financial Stability Paper 27, November 2013.
44 See European Systemic Risk Board, ESRB report on regulatory treatment of sovereign exposures, March 2015.

ise of securing more favourable financing terms.

Flaws in financial market constraints on governments' propensity to borrow

In the past, the ability of financial markets to effectively constrain the borrowing propensity of fiscal policymakers was limited by two key flaws. First, investors were very tardy in reacting to a deterioration in a country's fiscal sustainability and then tended to react very abruptly.[45] The resulting rising interest burden, especially for sovereigns with substantial short-term borrowing, often made it harder for fiscal policymakers to take timely countermeasures. This being so, it would be better for states to fund their routine financing needs through longer-term debt as this would give them more time to react in the event of abrupt market reassessments. Second, in some cases fiscal policymakers were themselves slow to react to the interest rate signals. The aforementioned proposals should help to mitigate these problems. Even so, there will still very likely be limitations to the disciplining effect of financial markets – as of fiscal rules – in the future. It therefore seems prudent to pursue both avenues in order to achieve sound government finances in the long term.

Need for a crisis resolution mechanism free from moral hazard

Crisis resolution mechanism should aim for the swift restoration of solvency

Despite reforms to the fiscal policy framework and supplementary measures to improve financial stability, the possibility of member states encountering solvency difficulties in future, along with the emergence of attendant systemic risks, cannot be ruled out. A credible crisis resolution mechanism is required for this contingency. Ideally, it should neither create moral hazard for national fiscal policymakers nor undermine the no-bail-out principle, and hence the disciplining effect of financial markets on fiscal policy. It should prevent systemic contagion effects in the financial sector and related spillover effects on the real economy. The fundamental objective should be the swift restoration of confidence in a country's solvency.

For illiquid countries: reform and consolidation programme and, if need be, supplementary liquidity assistance from public institutions

The appropriate course of action depends on whether the state in question is merely illiquid, with a fundamentally manageable debt situation, or overindebted.[46] In the first scenario, it may be possible to secure the state's capital market access and solvency simply by agreeing a sustainable reform and consolidation programme. However, even if a country is merely illiquid, such a programme typically needs to be implemented before capital market confidence in the country's long-term ability and willingness to pay can be restored. It is therefore likely that temporary assistance from the ESM or other public institutions, or a debt moratorium, will additionally be required. Central banks are prohibited from making a financial contribution to the crisis resolution mechanism because of the prohibition on monetary financing.

For overindebted countries: one-off wealth levy worth considering as crisis resolution instrument

If a country is overindebted, the first thing that must be done is to map out a sustainable debt reduction path. This is also a prerequisite for receiving liquidity assistance from the ESM. If debt sustainability is gravely endangered and unlikely to be achieved through conventional consolidation measures and reforms, extraordinary fiscal measures should also be considered in order to avert a sovereign debt haircut if possible. Particularly in cases in which the overindebted country is also home to considerable private wealth, a one-off redistribution of assets within that country might well be considered, for exemple, before any attempts are made to restructure its outstanding debt. This could, say, take the form of a one-off levy on

45 See European Central Bank, The determinants of euro area sovereign bond yield spreads during the crises, ECB Monthly Bulletin, May 2014, pp. 67-83.
46 In practice, it is very difficult to differentiate between illiquidity and overindebtedness. Thus far, all euro-area countries that have received help from an assistance programme have been assumed to be illiquid but solvent. While the majority of these countries have since successfully ended their programmes and have been able to return to the capital market, a haircut was carried out on private holdings of Greek government bonds barely two years after the start of the Greek programme.

residents' net assets. Such a move could make a noticeable contribution to ensuring the sustainability of a country's debt situation. In principle, this would hold the electorate accountable for its voting behaviour and sensitise it to the significance of such votes. This should increase incentives to strive for a fiscal policy that is fundamentally stability-oriented. If a country is increasingly unable or unwilling to repay its debts, the possibility of a one-off wealth levy being required as part of either an adjustment programme or a debt restructuring can prevent the debtor state (and thus its electorate) from looking for a quick fix to its debt burden at the expense of the country's creditors.[47]

Regulated procedure preferable for sovereign haircut event

If an overindebted country does carry out a debt haircut, a regulated procedure within the framework of a properly structured sovereign insolvency regime – potentially with the ESM as the coordinating body – as described above would be preferable to an unregulated approach. If the ESM defines fiscal and economic policy conditionality under this framework and makes the provision of liquidity assistance dependent on compliance with it, this could also potentially make it easier for private creditors to agree to a required debt haircut. In addition, the conditionality would counteract any incentives the debtor state may have to seek a quick-fix solution at the creditors' expense and would therefore also discourage unsound fiscal policy in the first place.

Beneficial automatic maturity extension of euro-area government bonds when ESM assistance is granted

As proposed above, the inclusion of a standard clause in euro-area government bond contracts stipulating automatic maturity extension in the event that ESM assistance is granted is particularly beneficial in this context. It not only improves the disciplining effect of financial markets on fiscal policy, but also significantly reduces the volume of public assistance required, as financial investors would remain liable for their investment decision if ESM assistance were to be granted.[48] Thus they can still be called upon if a subsequent debt restructuring becomes necessary.

ESM assistance loans must be free of moral hazard

ESM assistance loans to bridge temporary liquidity difficulties should be strictly tied to compliance with the reform and consolidation programme agreed with the given country. Even a change in government in the state receiving the assistance or in the creditor countries must not be allowed to fundamentally call these agreements into question. Reliable conditionality is an essential prerequisite for tackling the root causes of solvency problems and for the country in question to regain trust and access to the capital markets through its own efforts. It is also of key importance for gaining the confidence of the assistance-providing countries, which in effect provide *ex ante* loans without a repayment guarantee. Perceptible interest rate mark-ups on the refinancing costs of assistance loans should likewise provide governments with incentives to swiftly consolidate their public finances in order to lower the risk spreads as soon as possible and return to the capital markets. In addition, in order to protect taxpayers in creditor member states, public funds should generally be excluded from any subsequent restructuring, as is currently agreed in the case of ESM assistance loans.

Overall package improves sustainability of public finances and limits systemic risks of a sovereign haircut

Overall, the proposed measures for a more rigorous implementation of the European budgetary rules, the strengthening of the role of financial markets as a counterweight to fiscal policymakers' propensity to borrow and an improved crisis resolution mechanism may help to achieve greater sustainability in public finances. In conjunction with the aforementioned supplementary reforms to strengthen the financial system's loss-absorbency and to improve the resolvability of systemically important banks, these measures would contain the systemic risk arising from a not inconceivable sovereign debt

47 For more information see Deutsche Bundesbank, A one-off capital levy: a suitable instrument for solving national solvency crises within the current EMU framework?, Monthly Report, January 2014, pp. 49-51, and G Kempkes and N Stähler, A one-off wealth levy? Assessing the pros, the cons and the importance of credibility, Fiscal Studies, forthcoming.
48 For the duration of the maturity extension period, funds would only be required to finance the deficits and no longer to redeem maturing government bonds.

haircut and underpin the credibility of the no-bail-out principle.

Prevent or correct misguided macroeconomic developments

National sovereignty not infringed even by the excessive imbalance procedure

The introduction of the procedure for monitoring and correcting macroeconomic imbalances has provided monetary union with an important crisis-prevention tool that was previously lacking. Its objective is to counteract cross-border risks and economic policy developments that cause negative spillover effects on other member states and, in particular, on the functioning of monetary union. The reform was carried out within the existing legal and institutional framework, which means it does not encroach on the legally enshrined national sovereignty in the area of economic policy. The implementation of the economic policy recommendations of the European level therefore depends on the willingness and ability of member states to take these into consideration within the framework of their national economic policies. An advantage in this context is that, in the course of monitoring, macroeconomic imbalances can be identified by means of transparent analysis as this reveals problems to voters and capital market players, who can then put pressure on policymakers to take remedial action.

Still too early for robust evaluation of procedure

At the end of November 2014, the European Commission published a communication on the review of the EU's new economic governance regulations.[49] The gist of the communication, which seems reasonable, is that it is too early to draw meaningful conclusions regarding the impact of the procedure because of the short period in which it has been in force. This is underscored by the fact that, in a number of EU countries, macroeconomic imbalances were already in the process of being corrected by the time the excessive imbalance procedure was implemented in 2011, so that the procedure can only be put to the test in future periods in which imbalances first arise.

Inadequate use of the procedure by the Commission and overreliance on member states' reform promises

It must be said, however, that the European Commission's evident reluctance to fully utilise the steps available under the procedure merits a critical assessment. Thus the number of countries in which it has identified an excessive imbalance has risen from zero in 2012 to five in 2015. Yet the European Commission has not initiated excessive imbalance procedure in a single case to date, and this year, too, it has not yet issued any proposals to initiate such a procedure. Furthermore, when assessing the extent of imbalances, the Commission places too much importance on member states' reform promises, whereas experience shows that they are then only partially implemented or not implemented at all.[50]

Acceptance at national level an unresolved problem

A general problem, which ultimately also applies to the excessive imbalance procedure, is the often low acceptance in the individual member states of economic policy recommendations formulated at EU level, which are often seen as encroachments on national sovereignty. As part of its review, the Commission therefore calls for incentives for better implementation of the reform recommendations by the member states, though it fails to spell out what form these incentives should take. It should also be noted that the European level's diagnostic capability is not necessarily superior to that of the member states. This would suggest that the subsidiarity principle should apply as extensively as possible in order to prevent attempts by the Commission at macroeconomic fine-tuning. That being said, a purely national view that neglects the negative consequences for other member states and monetary union as a whole can be equally problematic. For example, a smaller country might opt to pursue a risky structural policy – such as growing a large financial sector – if it sees po-

49 See European Commission, Economic Governance Review, November 2014.
50 See European Central Bank, Economic Bulletin, 2/2015, pp. 53 ff.

tential advantages at the national level, while offloading a large portion of the negative risks onto the Community, for example via the banking union.

Financial incentives to reform unconvincing

The proposal made in the debate on the potential deepening of economic and monetary union to use extensive financial payments to overcome national resistance to Brussels' reform recommendations seems unconvincing.[51] Among other things, this would create incentives to put up fierce initial resistance to reforms and then subsequently demand large amounts of financial compensation in return for implementation. It would be rather difficult to justify a situation in which funds are granted when unsound developments arise and are corrected but not when unsound developments are avoided in the first place.

Stronger integration of national parliaments potentially helpful

Experience has shown that a comprehensive reform process in an affected member state can only really get off the ground and be successful if a large proportion of national policymakers and voters are convinced of the need for the recommended adjustments and are also prepared to see them through. A stronger integration of national parliaments could therefore be helpful. However, future amendments to the coordination mechanism should avoid making procedures altogether too complicated.

The role of monetary policy

Focus on price stability in compliance with market principles

The primary objective of the European System of Central Banks is to ensure price stability, and this is why it was granted independence, particularly from national governments. An essential counterpart to this independence is a monetary policy approach that is focused as narrowly as possible on the ESCB's price stability mandate and kept at arm's length from fiscal activities. Moreover, monetary policymakers must pursue this objective in compliance with market principles. The European treaties, which also govern the Eurosystem, are rooted in the principle that free competition is a prerequisite for the efficient allocation of resources. This makes it essential that monetary policymakers do not contribute to an imbalance between liability and control in other policy areas.

Monetary policy must not be misused to neutralise market forces

In other words, monetary policymakers must ensure in the course of their activities that responsibility for liquidity management ultimately remains with the commercial banks and that banks' funding costs are determined by market forces.[52] Banks which cannot raise funds on the money and capital markets, or which can do so only at prohibitive expense, must not be kept on life-support indefinitely by the central bank. Otherwise this could lead to a misallocation of resources.

Institutional segregation of monetary policy and banking supervision needed in the long term

Banking supervision should not be based at the ECB but instead at an independent institution that has the final say on supervisory matters, or at the very least, the decision-making structures for monetary policy and banking supervision at the ECB should be clearly segregated so as to avoid conflicts of interest between the two policy areas. Against this backdrop, the aim should be to amend European primary law in the long term to achieve an institutional separation of monetary policy and banking supervision at the European level.[53]

Monetary policy must not undermine the regulatory framework for fiscal policy

Just like the abovementioned comments on private responsibility for risks in the financial system, where monetary policy interacts with fiscal policy, the risks taken by fiscal policymakers are the responsibility of national governments and must be shouldered by the member states themselves. This means that, in this respect, too, monetary policy must not be allowed to

51 On this proposal see European Commission, A blueprint for a deep and genuine economic and monetary union: Launching a European debate, Communication from the Commission, November 2012.
52 For more information see Deutsche Bundesbank, Implications of the Eurosystem's monetary operations during the financial crisis, Monthly Report, April 2014, pp. 37-59.
53 For more information see Deutsche Bundesbank, Launch of the banking union: the Single Supervisory Mechanism in Europe, Monthly Report, October 2014, pp 43-64.

undermine the disciplining impact of the market. Measures aimed, for example, at reducing the financing costs of individual member states affected by rising risk spreads should be viewed critically in this context. Equally, monetary policymakers must not use the central bank's balance sheet to communitise sovereign debts via the back door.

Monetary policy and macroprudential policy

As both monetary policy and macroprudential policy target the financial sector, interactions between these two policy areas are inevitable. At the current juncture, however, there is only limited experience and scant knowledge in respect of macroprudential instruments as to their mode of operation, calibration and interaction both among themselves and with monetary policy. Nevertheless, the recent past has shown that the monetary policy stance can influence, in particular, the risk-taking propensity of financial market participants. Monetary policymakers should therefore also duly consider the implications of their decisions for the stability of the financial system as a whole. However, they can only do so within the scope of their mandate. Ultimately, this suggests that monetary policy should be applied symmetrically over the financial cycle and that policymakers should also weigh up medium and long-term risks to price stability. Such a symmetric monetary policy could help prevent financial market participants assuming too much risk.[54]

Conclusions

Establishing a coherent economic policy framework …

The crisis has pinpointed the need to reform the regulatory framework of monetary union. Many reforms and changes have since been implemented, often as short-term reactions to stress events. One of the fundamental questions raised is whether a fiscal or political union could be a viable objective. Given the evident lack of political support for such a scheme in the member states, it would seem that this path, along with comprehensive changes to EU primary law, is no longer on the agenda. As long as this remains the case, the existing regulatory framework must be made as crisis-proof as possible in the medium to long term.

… requires corrections and additional measures in various areas

The current constellation of growing joint liability, euro-area-wide risks to financial stability from potential unsound developments in individual member states, and extensive national autonomy in economic and fiscal policy is contradictory and unstable. This makes monetary union susceptible to new crises, and there is a risk of monetary policymakers being pressured into subjugating the objective of price stability to other general concerns such as securing financial stability or sovereign solvency, which are actually the responsibility of other political actors. If the current basic principles governing economic policy in the euro area, such as extensive national autonomy in economic and fiscal policy, continue to prevail, corrections and additional measures will therefore be required in various areas.

Strengthen financial stability through better loss-absorbency and improved resolvability of banks and ending the privileged status of government bonds in banking regulation

In terms of financial stability, further measures to strengthen banks' loss-absorbency and to improve the resolvability of financial institutions could promote a situation in which state funding for distressed banks is only required in extreme cases in order to avert a systemic crisis. It is equally crucial to curtail negative spillover effects of unsound public finances on financial stability. For this to happen, it is essential that a sovereign debt haircut can be carried out in future without raising fears of a systemic financial crisis. Only then will the no-bail-out principle applicable to other states, the Community, and monetary policymakers be credible and only then will financial markets more adequately assess the risk of a state being unable or unwilling to repay its debts. In this regard, considerable progress could be made if the existing favourable treatment of government debt securities in banking regulation were to be pared back in the medium term and abolished in the long term. Banks' exposures to sovereigns

54 For more information see Deutsche Bundesbank, The importance of macroprudential policy for monetary policy, Monthly Report, March 2015, pp. 39-71.

would then also require risk-appropriate capital backing and be subject to rules on large exposure limits.

Improve fiscal rules, strengthen disciplining role of financial markets and overhaul crisis resolution mechanism

In the area of fiscal policy, budgetary surveillance could be transferred to an independent institution mandated exclusively to safeguard sound public finances. In addition, the European fiscal framework, particularly the Stability and Growth Pact, should be tightened and, above all, actually implemented. If the Community level is not to be granted rights of intervention into the budgetary sovereignty of member states, then the disciplining effect of financial markets on fiscal policy will play an important role, irrespective of the fiscal rules. Lastly, the current crisis resolution mechanisms should be improved. For example, government bond contracts could be adjusted (single-limb collective action clauses, *pari passu* clause, automatic maturity extension upon the granting of ESM assistance), and a framework could be established to make sovereign insolvency procedures as orderly as possible. The ESM could be given an important role in this context.

Too early to reliably assess the need for further action on macroeconomic imbalances

In terms of macroeconomic developments, the introduction of the procedure for monitoring and correcting macroeconomic imbalances already represents a significant step forward. It is not yet possible to say with any certainty whether further reforms will be required, although so far the European Commission has adopted a fairly lax approach to implementation. Possible options to improve the acceptability of the Commission's recommendations by the member states include stronger integration of national parliaments and a streamlined and focused design of the rather complex European coordination frameworks.

Proposed reforms would take the pressure off monetary policymakers and contribute to a stability-oriented monetary union

All in all, the proposed reforms in the areas of financial stability and fiscal policy, in particular, would mitigate the risk of monetary policymakers being pressured into carrying out tasks outside or at the very limits of their mandate. In the upshot, this could make an important contribution to securing a stability-oriented monetary union.

Approaches to resolving sovereign debt crises in the euro area

During the course of the financial and sovereign debt crisis, a number of new mechanisms were created to foster coordination and overcome crises. The frequent increases in mutualised liability, with the exception of the banking union, have not, in practice, been accompanied by an intensification of joint control and decision mechanisms. Instead, the original governance framework of the European monetary union (EMU) has essentially been retained. Despite the implementation of additional coordination mechanisms, the member states are still largely accountable for their own fiscal and economic policy. At present, there do not appear to be majorities in favour of transferring sovereign rights, which would be necessary in order to make a major step towards deeper integration in a comprehensive fiscal and political union. In this case, reform efforts should aim to strengthen the basic principles agreed for the euro area and to safeguard the price stability-oriented monetary policy.

When combating sovereign debt crises in the euro area, it is, in principle, prohibited for either the other member states or the Eurosystem to shore up a member states' solvency. It is therefore crucial to ensure sound public finances at the national level and to strengthen financial stability by limiting the negative interplay between governments and systemically important financial institutions on a long-term basis. This ultimately implies that the monetary union must also be able to withstand the extreme scenario of a default of a member state. The European Stability Mechanism (ESM), which was set up in 2012, plays a decisive role in combating fiscal crises. In the event of liquidity problems, the ESM can provide financial assistance by implementing adjustment programmes. However, this presumes that the debt burden of the country in question is sustainable.

On the basis of past experience, this article presents a number of approaches aimed at improving the euro-area crisis resolution mechanism in the medium to long term and also to allow a necessary restructuring to be carried out in an orderly manner. This concerns, for one thing, the standardised conditions for future government bond issues (the bond terms). For instance, the inclusion of an automatic extension of maturities in the event of the implementation of an ESM programme could help to better distinguish between temporary liquidity problems and fundamental sustainability problems, as well as to strengthen the individual responsibility of investors, increase the clout of the ESM and contain the transfer of risk to the public sector and the other member states. Furthermore, in the event of overindebtedness, the necessary agreement between debtors and creditors could be simplified and accelerated by replacing the majority requirement in the collective action clauses with a one-limb procedure. Moreover, should a restructuring become necessary, it would also make sense to implement a more rule-bound procedure and to lay down the assignment of the necessary coordinating tasks in order to ensure an orderly and transparent procedure. This could mitigate the problems associated with a sovereign debt crisis. Ultimately, these additions could help to make a significant contribution towards strengthening the current no-bail-out principle and the member states' individual responsibility and thus, going forward, also towards reducing the likelihood of a government becoming overindebted.

Introduction

Proposals to ensure a more effective resolution of sovereign debt crises

In March 2015, the Bundesbank published an overview of the changes made to the governance framework of the EMU since the onset of the financial and sovereign debt crisis as well as a number of different approaches to make the framework more resilient.[1] This article focuses in greater depth on ways to combat sovereign debt crises in the euro area, including debt restructuring. It begins by addressing central measures and reforms in the euro area and the key elements required to create a consistent governance framework for the EMU. In a further step, it then looks at selected challenges in connection with the resolution of government financing crises and any necessary debt restructuring, before moving on to discuss possible reform approaches.

The financial and sovereign debt crisis has highlighted the need for reform in the governance framework of the EMU

The crisis saw assistance mechanisms created and reforms implemented

During the financial and debt crisis, a number of euro-area member states were cut off from the capital markets and financial stability in the euro area appeared to be in jeopardy. In view of these risks, financial assistance was granted by the other member states, and the ESM was set up to ultimately act as a permanent assistance fund. At the same time, a number of reforms were implemented which, among other things, were intended to mitigate the mutual reinforcement of problems in the financial sector and in public finances (sovereign-bank nexus).[2] In order to prevent or correct future undesirable macroeconomic developments, the macroeconomic imbalance procedure was introduced. It was also envisaged that the Stability and Growth Pact be toughened up and more firmly anchored across national regulations with the aim of ensuring sound public finances. With its first pillar, the Single Supervisory Mechanism (SSM), the banking union is intended to help forestall financial distress in the banking system. With its second pillar, the Single Resolution Mechanism (SRM), the aim is, among other things, to avoid having to use government funds in future to bail out the banking system.[3]

Problems with the current design

These reforms may contribute towards the prevention and resolution of future crises. However, with the exception of the banking union, the increases in mutualised liability have not, in practice, been accompanied by any substantial intensification of joint control and decision mechanisms. Furthermore, the design and implementation of the new regulations, such as in the area of fiscal rules, raise considerable doubts regarding their effectiveness.[4] Nor has adequate progress been made to date in containing the direction of impact of the fiscal distortions from the government to the banking

1 See Deutsche Bundesbank, Approaches to strengthening the regulatory framework of European monetary union, Monthly Report, March 2015, pp 15-37. For information on the causes and implications of the financial and sovereign debt crisis, see Deutsche Bundesbank, Adjustment processes in the member states of economic and monetary union, Monthly Report, January 2014, pp 13 ff. For an overview of the recommended measures and reforms, see p 44.
2 The role of monetary policy in the financial crisis and in preventing and combating crises is not the focus of this article. For more information, see, for example, Deutsche Bundesbank, The macroeconomic impact of quantitative easing in the euro area, Monthly Report, June 2016, pp 29 ff; Deutsche Bundesbank, The importance of macroprudential policy for monetary policy, Monthly Report, March 2015, pp 39 ff; as well as Deutsche Bundesbank, The implications of the financial crisis for monetary policy, Monthly Report, March 2011, pp 53 ff.
3 For more information, see Deutsche Bundesbank, Europe's new recovery and resolution regime for credit institutions, Monthly Report, June 2014, pp 31 ff; as well as Deutsche Bundesbank, Launch of the banking union: the Single Supervisory Mechanism in Europe, Monthly Report, October 2014, pp 43 ff.
4 See, for example, Deutsche Bundesbank, Fiscal developments in the euro area, Monthly Report, May 2016, pp 61-65; Deutsche Bundesbank, The implementation of fiscal rules in the European monetary union, Monthly Report, December 2014, pp 8-10; or also European Court of Auditors, Further improvements needed to ensure effective implementation of the excessive deficit procedure, Special Report No 10/2016.

system.[5] On the whole, quite a number of loopholes have yet to be closed, and the imbalance between liability and control potentially creates substantial misguided incentives for policymakers and financial market participants alike.[6]

Need for a consistent governance framework for the EMU

Deeper economic and fiscal policy integration could prove to be a consistent reform option for the euro area. Even if the corresponding proposals are often primarily aimed at expanding joint liability even further,[7] a greater depth of integration would, however, require that relevant decision-making powers also be transferred to democratically legitimate European institutions, and ensuring a stability oriented policy as a whole.[8] However, national policymakers are not pursuing a change to the EU treaties at present and there are no apparent majorities in favour of surrendering sovereign powers. As long as this remains the case, the priority must be to strengthen the agreed governance framework for the euro area.[9] In this regard, the euro area is based on an independent monetary policy with a clear mandate to safeguard price stability, and it places an emphasis on the individual responsibility of the member states and the financial market participants. The formation of a fiscal bail-out community and the financing of governments through monetary policy are, however, prohibited.

No-bail-out principle credible only if further reforms are implemented

This means that government financing difficulties, and also the possibility of a euro-area member state defaulting, cannot be ruled out. The crisis has, however, shown that this framework is stretched to its limits when the economic and political costs resulting from sovereign solvency problems are considered to be much higher than the costs involved in granting public financial assistance. This can be expected, in particular, where financial stability as a whole appears to be threatened, and the costs of a default occur in the short term, while those arising from granting financial assistance are more of a medium to long-term nature. Against this backdrop, the ESM saw the creation of a support mechanism to provide assistance in the event of government liquidity problems. As a general rule, however, the ESM is not allowed to grant funds to overindebted governments, and the possibility of a default is not ruled out. Therefore, further reforms should aim to anchor a stability-oriented fiscal policy in the member states, to prevent systemic contagion effects as far as possible and to strengthen financial stability as a whole. Ultimately, macroeconomic imbalances, excessive government debt or even a (partial) default must also be manageable. Otherwise, the euro area is likely to remain vulnerable to crises. An overview of the reforms and measures proposed and discussed in further detail in the Bundesbank's March 2015 *Monthly Report* can be found in the table on page 44.

Challenges for the crisis resolution mechanism in the event of sovereign debt crises

Effective crisis management fraught with challenges

The ESM plays a central role in combating sovereign debt crises in the euro area. It is permitted to grant financial assistance to member

5 In order to limit banks' risk arising from sovereign exposures, it is currently being debated whether the preferential regulatory treatment of sovereign debt securities should be reduced. It would also be important to back these claims with capital in a risk-appropriate manner and to implement large exposure limits in order to sever the sovereign-bank nexus. It would be essential to ensure that any losses which could occur elsewhere outside of banks' balance sheets remain manageable for the financial market as a whole. For more information, see Deutsche Bundesbank, Reducing the privileged regulatory treatment of sovereign exposures, Annual Report 2014, pp 23 ff.
6 See, for example, German Council of Economic Experts, Consequences of the Greek crisis for a more stable euro area, Special Report, July 2015.
7 See J C Junker, D Tusk, J Dijsselbloem, M Draghi and M Schulz, Completing Europe's economic and monetary union, The Five Presidents' Report, Brussels, June 2015.
8 Effective control of joint liability instruments is not possible without surrendering relevant decision-making powers. See Expert Group on Debt Redemption Fund and Eurobills, Final Report, March 2014.
9 See, for example, German Council of Economic Experts, European economic policy: stable architecture for Europe – need for action in Germany, Annual Report 2012/13, pp 102 ff; as well as German Council of Economic Experts, Against a backward-looking economic policy, Annual Report 2013/14, pp 156 ff.

Summary of selected recommendations and measures*

Financial stability	Fiscal policy	Economic policy
Strengthen banks' loss absorbency: capital requirements and/or leverage ratio Consistently deploy and refine macro-prudential toolkit Improve integration of equity and debt markets – Uniform legal framework – Diversified lending Segregate monetary policy and banking supervision Single Resolution Mechanism (SRM) – Adequate bail-in-able capital – Apply bail-in rules strictly, and stringently wind down non-viable banks – Common fiscal backstop with national loss retention Properly regulate financial system outside the banking sector (eg shadow banks), too	Set up independent budgetary surveillance institution Fiscal regime – Simpler and clearer rules, strictly applied – Uniform and transparent surveillance – Reduce discretionary leeway – Step up automatic corrective measures – Strengthen role of debt ratio ESM – Conditional liquidity assistance – Interest rate mark-ups for assistance – **Stronger role in insolvency process[1]** – Non-standard fiscal measures to avert or mitigate haircuts	Review imbalance procedure and adapt if necessary once sufficient experience has been gathered; implement strictly Streamline and enhance transparency of European coordination mechanisms Take account of cross-border effects, but no fine-tuning of economic policy by central authority
Deprivilege sovereign bonds – Capital backing – Large exposure limits – Adapt liquidity rules **Revise sovereign bond contracts[1]** **– Collective action clauses with single-limb aggregation** **– Automatic maturity extension if ESM assistance granted** **Create framework for more orderly sovereign insolvency[1]**		

Monetary policy	
Keep focus on core objective of price stability Define mandate narrowly so as to legitimise independence Do not undermine unity of liability and control in other areas or distort market processes	Assume no responsibility for financial stability risks caused by sovereigns' and banks' solvency problems Avoid engineering joint liability for sovereign solvency risks via central banks' balance sheets Institutional segregation of monetary policy and banking supervision

* See Deutsche Bundesbank, Summary of selected recommendations and measures, Monthly Report, March 2015, p 23. **1** These aspects are discussed in greater detail in this article.
Deutsche Bundesbank

states that have been cut off from the financial market, but not to overindebted governments, on the condition that the member state in question adopts an economic and fiscal adjustment programme.[10] If, despite a reasonable level of own efforts, major doubts still exist regarding debt sustainability, these are to be cleared up in advance by adopting suitable measures such as by involving private creditors (debt restructuring). In the interest of an effective crisis resolution, the objective is first and foremost to minimise the macroeconomic damage, to support stable macroeconomic developments and to safeguard the long-term sustainability of public finances.

Distinguishing between temporary financing difficulties and fundamental sustainability problems

Reliable assessment of acute government financing difficulties

When a government experiences acute financing difficulties in the capital market, it is often challenging to determine whether this is due to just a temporary liquidity shortage, which can be overcome by providing liquidity loans through an assistance programme, or due to a

10 See Deutsche Bundesbank, European Council decisions on the prevention and resolution of future sovereign debt crises, Monthly Report, April 2011, pp 53-58.

fundamental problem of the government's ability or willingness to pay. The assessment of the macroeconomic and fiscal perspectives and, in particular, the assertiveness of governments in implementing unpopular consolidation measures play a decisive role in this context. It is often the case that only during the course of an adjustment programme is it possible to see whether the causes of the acute financing difficulties can be rectified by implementing the agreed reforms (liquidity problem) or whether debt restructuring is required (fundamental sustainability problem). A crisis resolution mechanism should prevent debt restructuring from being carried out in the event of a liquidity problem and creditors from receiving a full payout in the case of a sustainability problem.

Make governments and investors accountable for their actions

Preserve responsibility of governments and investors

An effective crisis management strategy should preserve the responsibility of the member state concerned and the investors. Thus, within an adjustment programme, the citizens of the member states should remain primarily responsible for the solution to national financial problems. The member states are ultimately solely responsible for deciding on and implementing the domestic distribution of the adjustment burden (ownership). If it becomes apparent over time that the government's ability to pay cannot be restored by this alone, the creditors should be held accountable for their investment decisions and not released from their liability by granting public financial assistance.

Avoid delays in implementing necessary adjustment measures

Avoid tendency to delay crisis resolution

Where government financing problems occur, both the debtor country and its creditors could have an interest in delaying the implementation of crisis resolution measures (gambling for resurrection). Often, a government may want to avoid the political costs involved in implementing an adjustment programme or in debt restructuring. In addition, the predominately negative impact of a necessary consolidation on economic activity in the short term is likely to cause the parties concerned to hope that the economic situation improves by itself without resorting to any measures, and to put off a necessary restructuring until it becomes unavoidable. Creditors, by their very nature, have an interest in receiving a full payout of their claims. They will hope that a necessary debt restructuring will be delayed or will not materialise or that the adjustment burden will be carried by other private or public creditors. A delayed crisis resolution is, however, associated with prolonged spells of uncertainty and, as a rule, has a negative impact on further economic developments and increases the economic costs. In this respect, it is important that the necessary adjustment processes are initiated in a timely manner.[11] At the same time, a mechanism of this kind must not present governments with an easy way to be rid of their debt burden. The incentives for ensuring a sustainable fiscal and economic policy must be preserved.

Preserve the clout of the ESM in tackling crises

The higher the level of ESM funding required in a specific case, the lower its effectiveness

The ESM has limited resources at its disposal, which means that it is essential to keep the use of the ESM's funds to a minimum in each specific case. This, however, also applies with regard to the incentives for investors to make an appropriate risk assessment and to limiting the burden on the taxpayer in those countries providing assistance. In the case of the assistance programmes in place to date, however, large

11 The reduction in uncertainty is also of key importance when dealing with debt problems in the private sector. For more information, see Deutsche Bundesbank, Adjustment processes in the member states of economic and monetary union, op cit.

parts of public funds have been used to finance maturing bonds, resulting in the funds being rapidly depleted, and private investors have, at least in part, been released from their liability.

Should restructuring prove inevitable, make the procedure efficient

Effective crisis management by means of structured procedure in the event of overindebtedness, …

Acute government financing difficulties and the threat of overindebtedness harbour the risk of disorderly developments, not only limiting fiscal policy leeway but also placing a strain on the financial system and even, in extreme cases, on the functional viability of the national economy as a whole. Due to the close (financial and) economic interdependencies that exist in the euro area, contagion effects on other member states are foreseeable. The ESM is designed to prevent critical escalation and avoid the economic cost of the disorderly developments that would otherwise tend to follow. However, there is no procedure laid down in current regulations on how to carry out the inevitable process of debt restructuring in the event of a government running up excessive debt. That being said, an effective crisis management resolution should, in the interest of all parties concerned, bring with it planning certainty and help debt restructuring negotiations run smoothly. In this way, it is possible to limit the burden arising from consolidation measures, a haircut and macroeconomic side-effects. It is therefore necessary to reconcile the interests of all parties concerned, and to foster an environment in which all claims receive equal treatment, especially by minimising the associated coordination issues.[12]

… which, inter alia, limits holdout problem

From the creditors' viewpoint, it is only expedient to agree to a haircut if there would otherwise be a danger of even higher losses, and if the value of their remaining claims would subsequently seem safer. The latter presupposes confidence in the crisis resolution mechanism, the debtor country's willingness to reform and pay, and improved macroeconomic and financial prospects following restructuring. If there is any doubt in this regard, creditors are more likely to try to avoid losses and press for the regular payment of their claims.[13] Potential conflicts between creditor groups exacerbate the problem, especially when individual investors refuse to cooperate and are able to enforce their claims at the expense of the other creditors (holdout). The lower the haircut, the more likely creditors are to agree to debt restructuring. This entails the risk of restructuring proving insufficient, thus possibly rendering it necessary to restructure the debt again or placing a strain on the crisis resolution mechanism in future.

Reform options for a crisis resolution mechanism to tackle sovereign debt crises in the euro area

Improve future crisis management

This section outlines ways in which the existing crisis resolution mechanism could be improved. These include changes to the current standard terms of sovereign bonds issued by euro-area

12 The lessons learned from the restructuring of Greek debt in 2012 illustrate the problems with the current procedure. A liquidity problem was assumed when the first economic adjustment programme was negotiated. Over the course of this programme, private creditors were released of liability when their debt instruments matured and risks were transferred to the public creditors. The excessive level of Greek debt became apparent during the second economic adjustment programme. The participation of the remaining private creditors in the debt restructuring was achieved by retroactively amending the bond contracts under Greek law and using additional funds provided by the fiscal assistance mechanisms. At the same time, creditors who primarily held Greek government bonds that had been issued under another legislation received full repayment. See Committee on International Economic Policy and Reform, Revisiting sovereign bankruptcy, Report, Brookings Institution, October 2013; and J Zettelmeyer, C Trebesch and M Gulati (2013), The Greek debt restructuring: an autopsy, Economic Policy 28(75), pp 513-563. The vast majority of debt restructuring carried out in recent decades took place in developing countries and emerging market economies. See D Udaibir, M Papaioannou and C Trebesch, Sovereign debt restructurings 1950-2010: literature survey, data and stylized facts, IMF Working Paper 12/203. The challenges surrounding crisis resolution and crisis management in the euro area differ from those.

13 Other countries or multilateral institutions could also, as creditors, have an incentive to hold out for an improved scenario that does not involve restructuring as, in addition to suffering financial losses, they could also be faced with significant political costs.

countries as well as core elements of a structured procedure in the event of debt restructuring.

Change standardised terms of euro-area sovereign bonds

Automatic maturity extension in the case of ESM programmes

Automatic maturity extension in the case of ESM programmes offers advantages

Euro-area member states finance themselves predominantly through bonds, for which they have agreed on standardised terms. In the case of newly issued bonds, these terms could be supplemented by a passage stipulating that their maturity will be automatically extended by three years, for instance, under identical terms as soon as a member state receives ESM assistance.[14] It is of particular importance in this context that the extension constitutes neither a restructuring nor a credit event, as this would form part of the bond's terms and be known when buying the bond.

Problems in reliably assessing the causes of acute financing difficulties …

It is necessary to perform a debt sustainability analysis before any assistance is provided under the ESM. In the event of overindebtedness, the first step would be to restructure the debt. If a liquidity shortfall were mistaken for overindebtedness, this could potentially lead to an ultimately unnecessary process of restructuring with all its unwanted side-effects. But what is likely to be of greater relevance in practice would be to initially fail to recognise a need for debt restructuring and instead first identify it as merely a liquidity problem.[15] Under the current set-up, financial aid is used to repay holders of maturing securities. Taxpayers in countries providing assistance assume considerable risks under the programme as, in addition to the deficits (including interest payments on sovereign debt), redemptions – which are generally far more substantial – are also financed.

… would be eased substantially

Automatically extending maturities would significantly mitigate the diagnostic problem. If no need for debt restructuring is identified, a country could receive financial aid under an ESM programme to cover its financing requirements,[16] adjustment measures would be decided on and implemented in a controlled manner, and bondholders would not be released of their liability. A decision pertaining to the possible need for restructuring could be made in further course when, once progress has been made in implementing the programme, a clearer picture emerges of the member state's macroeconomic and fiscal outlook. Should it nevertheless become necessary to restructure debt in further course, extending the maturities of government bonds could allow this to take place under less time pressure, based on a more certain outlook and therefore in a more targeted and orderly manner.

Reduced risk assumption of public creditors increases ESM clout

Compared with the *status quo*, the level of ESM funds deployed for each assistance programme would be considerably lowered. Consequently, its clout and credibility as a stabilisation mechanism would be enhanced, while the risks for taxpayers in the other member states would be significantly reduced.

Automatic maturity extensions in the event of government financing problems could provide a possible incentive for governments to use this

14 See Deutsche Bundesbank, Proposal for an effective private sector involvement for bond issues from mid-2013 onwards, Monthly Report, August 2011, pp 68-71; and Bank of England, Sovereign default and state-contingent debt, Financial Stability Paper 27, November 2013. To date, the programmes have run for three years, during which period uncertainty about further developments is likely to diminish substantially.
15 This diagnostic problem presents a particular difficulty with regard to the current design of the ESM assistance programmes.
16 A temporary maturity extension could even be triggered upon submitting an application if it were initially limited to the decision-making period envisaged under the procedure for an assistance programme (probably around one to two months). This would reduce the risk of unwanted default and ensure that liability remains with the investors during the negotiation period. The maturity would not be automatically extended by three years until the ESM programme was adopted. Any temporary assistance to cover acute financing needs above and beyond that would have to be made subject to special collateralisation requirements and, like regular financial aid, would be excluded from any debt restructuring.

Strengthened incentives for sustainable fiscal policy by linking it to adjustment programme …

time gained to postpone necessary – and politically uncomfortable – reforms. However, this could be counteracted by linking automatic maturity extensions to a commitment to adhere to a targeted reform programme. On the one hand, this results in the maturity of bonds purchased by creditors being extended; on the other hand, the probability of repayment should be higher compared with a procedure that does not involve a programme, as the financial aid provided and adjustment measures implemented under a programme would probably improve the outlook for sustainability significantly. In addition, restructuring would, on the whole, be less likely than in a scenario without a programme. It would therefore also remain in the creditors' interest for the implementation of the adjustment programme to succeed.

… and investors' heightened sensitivity to risk

Upon introduction of the maturity extension, government financing costs could most likely increase for those member states in which investors see the possibility of an ESM programme being implemented within the regular time span of their bonds. These investors would then assume that the maturity of their bonds would, with a certain probability, be extended. All other things being equal, however, it would be quite unlikely for a maturity extension to lead to an increase in financing costs such that they would, in total, exceed the costs associated with a bond running three years more, in which case the implementation of an ESM programme would already be firmly expected. Provided the yield curve were rather flat for medium to longer-term debt, interest effects would probably remain within limits overall.[17] Should this exacerbate the financing problems of a country in a doubtful financial situation, causing an application for ESM financial assistance to be submitted at an earlier date, this would also counteract the tendency to postpone necessary adjustment measures and, to this extent, should not be regarded as harmful.

Reform of standardised collective action clauses

Collective action clauses introduced in 2013 for euro-area government bonds improving coordination between creditors

Since 2013, all bonds issued by euro-area member states with maturities exceeding one year have been subject to a standardised euro collective action clause (Euro-CAC).[18] This allows a qualified majority of holders of an individual bond series to agree on a modification to the bond's terms that is binding for all holders of the series.[19] If a qualified majority in presence of a quorum of all outstanding bond series subject to the CAC votes in favour of modifying the bond terms, the majority needed to modify the term at the single series level is lowered (two-limb majority requirement). This reduces the incentive to hold out. However, such a two-limb decision cannot prevent a blocking minority from being achieved by purchasing a sufficiently high share of an individual bond series. It therefore cannot be ruled out that investors could act contrary to the vote taken by the creditor community by moving to block the restructuring of their bond and press for their claims to be met in full.[20]

17 The scenario of a programme-driven three-year postponement of maturities and redemption dates would need to be assigned a present value loss of the debt securities, the amount of which would depend on the yield curve. The higher this present value loss and the more investors consider it likely that an ESM programme will be triggered, the higher the spread they are likely to demand.

18 CACs are currently not mandatory for bonds with a maturity of less than one year, for regional and local government bonds or in loan agreements. See EFC Sub-Committee on EU Sovereign Debt Markets, Collective action clause explanatory note, July 2011; and Model collective action clause supplemental explanatory note, March 2012. The effectiveness of reform proposals would suffer if these forms of financing were not incorporated and utilised to a greater extent.

19 The majority requirement differs depending on the intended adjustment (reserved matter or non-reserved matter of the bond term) and the voting procedure (bondholder meeting or written resolution), and on whether a modification is to apply to an individual bond series (single series) or to multiple bond series at the same time (cross series). If a qualified majority agrees to debt restructuring, this will also affect bonds held by other countries, the Eurosystem or multilateral institutions.

20 See, for example, International Monetary Fund, Strengthening the contractual framework to address collective action problems in sovereign debt restructuring, IMF Policy Paper, September 2014.

Single-limb majority requirement neutralises incentives to hold out and purchase blocking minorities

The introduction of more comprehensive aggregation clauses would simplify and speed up the debt restructuring process. This would enable a qualified majority of creditors to be determined across all government bonds subject to the same CAC to trigger a debt restructuring (single-limb majority requirement).[21] Approval from the holders of each individual bond would then no longer be required. What is more, creditors would no longer need to worry about restructuring burdens being shifted to the rest of the creditor community as a result of individual investors successfully holding out. This should substantially reduce the holdout options and the incentive to purchase blocking minorities. In principle, the majority requirement for the first step of cross-series restructuring currently set out in Euro-CACs could be maintained for single-limb CACs.[22] Moreover, consideration could be given to lowering the majority requirement further in specific cases where restructuring is to take place as part of an ESM programme.[23] This could reinforce the crisis resolution mechanism. Nevertheless, it must be ensured that the bondholders' position is not unduly weakened. It would also be necessary in this context to prevent a fragmentation of bonds issued by member states into issues with different CACs.

Orderly procedure for any debt restructuring under an ESM programme

Rule-bound procedure could boost effectiveness of crisis management

The prerequisite for the provision of financial aid under the ESM's assistance and crisis resolution mechanism is the programme country's capacity to repay. Should a country be unable to repay, debt restructuring would require the involvement of private investors either prior to launching the programme or, if this does not become apparent until a later point in time, in further course. Under these circumstances, it makes sense to establish a reliable and transparent procedure beforehand.[24] This should create greater planning certainty and help keep friction losses, macroeconomic costs and ultimately also the haircut to a minimum.[25] Moreover, a rule-bound procedure is better suited to incorporating claims arising from bonds and loans into restructuring negotiations.

ESM could monitor procedure and take on coordination tasks

The ESM – which already plays a key crisis management role if euro-area member states face financing difficulties – would be a suitable choice for taking on a coordinating role should there be a need for a debt restructuring. In terms of an orderly procedure, the first step would be to define the rights and obligations in the relationship between the member states, the creditors and the ESM as restructuring coordinator, and to draw up a concrete timetable detailing when the individual steps in the procedure should be taken (for more information,

21 The introduction of single-limb aggregation clauses necessitates an adjustment to the uniform CACs of euro-area countries (Article 12(3) of the ESM Treaty) and of corresponding national regulations such as, for example, sections 4a et seq of the Federal Government Debt Management Act (Bundesschuldenwesengesetz).
22 Under Euro-CACs, the first limb with regard to a bondholder meeting calls for a qualified majority of 75% by principal amount of outstanding bonds represented at a quorate meeting of 66⅔% of the outstanding principal amount of the affected bond series; in the case of a written resolution, modifications require the approval of 66⅔%. If these majorities are achieved, the majority requirements are reduced in the second limb for the respective bond issues.
23 Majority requirements also play a significant role in the Eurosystem's purchase of government bonds on the secondary market, for example as part of a broad-based purchase programme (public sector purchase programme: PSPP).
24 With a view to assessing a country's financial situation and debt sustainability as objectively as possible, the procedure could still benefit from the currently envisaged – if possible – involvement of the IMF, with its expertise in accompanying reform and adjustment programmes and, where required, debt restructuring processes.
25 For further proposals on an orderly procedure, see F Gianviti et al (2010), A European mechanism for sovereign debt crisis resolution: a proposal, Bruegel Blueprint Series, Vol 10; Wissenschaftlicher Beirat beim Bundesministerium für Wirtschaft und Technologie (Scientific Advisory Board at the Federal Ministry of Economics and Technology), Überschuldung und Staatsinsolvenz in der Europäischen Union, Gutachten Nr. 01/11; G Corsetti et al, A new start for the eurozone: dealing with debt, Monitoring the Eurozone 1, CEPR Press, March 2015; and G Corsetti et al, Reinforcing the Eurozone and protecting an open society, Monitoring the Eurozone 2, CEPR Press, May 2016. See also C Fuest, F Heinemann and C Schröder (2016), A viable insolvency procedure for sovereigns in the euro area, Journal of Common Market Studies 54(2), pp 301-317; and J Andritzky et al, A mechanism to regulate sovereign debt restructuring in the Euro Area, German Council of Economic Experts, Working Paper 04/2016, July 2016.

Further proposals for reforming bond contractual terms

With the automatic maturity extension in the case of ESM programmes and adjustments to the majority requirements in collective action clauses, this *Monthly Report* article introduces important approaches to fundamentally change the terms of sovereign bonds issued by euro-area countries. If embedded in reforms of the governance framework of the EMU, these approaches could play a part in dealing with crises more effectively. Moreover, other changes to the contractual terms of future bond issues are currently being debated as well; two of these elements will be briefly outlined and discussed below. However, further analysis would be needed in order to better evaluate the desired advantages of each against the potential drawbacks.

Splitting bonds into tranches with lower and higher loss risk

In order to both mitigate the negative consequences of government financing difficulties for the financial markets and strengthen the credibility of the no-bail-out clause of the governance framework, it is crucial to break the strong sovereign-bank nexus that persists in the euro area. In particular, the purpose of the banking union is to help avert financial distress in the banking system and to prevent use of government funds for bail-out purposes. However, fundamental changes would also have to be made to banking and financial market regulation such that sovereign bonds are no longer considered as risk-free.[1]

With the aim of preventing undesired distortions as a result of government sustainability problems, reforms have been proposed which would increase the volume of safe assets for the financial markets and strengthen incentives to diversify, but without implying any further joint liability. Various concepts are currently under discussion.[2] One specific proposal[3] envisages bundling sovereign bonds of all euro-area countries into one bond according to a predefined key. With this instrument, each country would continue to be liable only for the bonds that it issues. The new securitised bonds would be divided into a junior (first-loss) tranche and a senior (second-loss) tranche, the latter constituting European safe bonds, or ESBies for short. Under the proposal, senior tranches would be excluded from the tightening of banking and financial market regulation with regard to holding sovereign bonds, even though more stringent regulation is generally considered necessary. The combination of diversification and tranching means that ESBies could indeed increase the volume of safe assets for the financial markets, although the individual member countries would continue to issue their bonds autonomously.[4] However, the proposed regulatory exemption for ESBies would, besides other practical problems, constitute a privileging of ESBies, for example, over highly

1 See Deutsche Bundesbank, Reducing the privileged regulatory treatment of sovereign exposures, Annual Report 2014, pp 23-40.
2 See, for example, M Brunnermeier et al, European safe bonds (ESBies), mimeo, September 2011; and G Corsetti et al, A new start for the Eurozone: dealing with debt, monitoring the Eurozone 1, CEPR Press, March 2015.
3 See M Brunnermeier et al, ESBies: safety in tranches, mimeo, May 2016.
4 Under the concrete proposal, the volume of potentially available ESBies is likely to depend on the actual division into junior and senior tranches as well as, primarily, on the pre-defined key by which sovereign bonds would have to be bundled. With a design such as this, the comparatively low level of government debt in individual euro-area member states would probably limit the ESBies issued.

rated national sovereign bonds.[5] In addition, the proposed mandatory composition of the bonds, which would then continue to benefit from preferential regulatory treatment, would be determined according to a specific key covering all euro-area countries. This would be tantamount to distorting risk premiums in favour of countries whose debt securities would otherwise be in less demand. At the end of the day, the pros and cons of tranched securities would depend on the specific design. A market-based solution[6] which does not provide for additional joint liability or preferential regulatory treatment would be compatible with the existing governance framework of the EMU, however.

As an alternative, tranching of the respective national bonds is currently also under discussion. This proposal, too, would require tighter banking and financial market regulation with a view to enabling systemically important financial institutions to cope with unsound developments in public finances or to be resolved in an orderly fashion in that risks stemming, in particular, from sovereign bonds are subjected to adequate regulatory requirements. In this context, dividing the individual national bonds into a junior and a senior tranche (national safe bonds, or NaSBies for short) could help to increase the volume of safe assets, thereby making it easier to implement the regulatory reform.[7] Here, each member state would have to continue issuing its bonds on its own responsibility. However, every bond would comprise two tranches, each with a pre-defined distribution of loss in the event of a debt restructuring (ie the two tranches would only be issued in tandem). Thus, this proposal is not about the separate sale or purchase of individual tranches of a bond issue, but about distributing government loss risks within a financial system with risk-appropriate regulation of government debt securities.

Nothing would change as a result for creditors of bonds already outstanding. All issued bonds, ie previously issued (untranched) bonds and the new (tranched) bonds, would have to be treated equally in debt restructuring negotiations. But for the new bond format, any loss on the bond – which would be identical to the loss on a non-tranched bond – would first have to be borne solely by the junior tranche. The second-loss (senior) tranche would only be affected once the junior tranche was completely used up.[8] If the prescribed division envisaged a 60% senior and a 40% junior tranche, say, the senior tranche would not

5 The concept currently on the table suggests possibly passing on the practical implementation, ie producing the ESBies, to private issuers. Beforehand, however, it would have to be clarified how to reliably ensure that earnings and, in particular, potential losses stemming from the financial intermediary's regular business activities do not affect the cash flows from the junior tranches and the ESBies, and vice versa. This could make it necessary to coordinate the issues of the underlying sovereign bonds to be able to prevent potential liquidity risks stemming from different cash flows at the intermediary. In addition, the specific procedure in the event of the resolution of an intermediary would have to take such potential interaction into account, and appropriate regulations would have to be laid down beforehand. An implicit or explicit government guarantee would create misguided incentives and increase the mutualisation of liability.
6 Tighter regulation with regard to holding sovereign bonds could give market participants an incentive to diversify as well as to create safer assets through securitisation and tranching. The weighting of the individual government bonds of such securitisations would then be the result of a market process.
7 See Deutsche Bundesbank, Approaches to strengthening the regulatory framework of European monetary union, Monthly Report, March 2015, pp 15-37; and K Wendorff and A Mahle, Staatsanleihen neu ausgestalten – für eine stabilitätsorientierte Währungsunion, Wirtschaftsdienst, September 2015, pp 604-608.
8 The new bond would initially have to be bought containing both tranches together. Investors could subsequently hold both tranches, sell individual tranches or sell both tranches together. If the bond were held with both tranches, this would be equivalent to purchasing a bond in the present form; in the event of a debt restructuring, a bond of this format would then be affected by a haircut to the same extent in financial terms as the "old" (present) bond format.

be affected by a haircut unless the haircut exceeded 40% of the total volume of all the outstanding sovereign bonds.[9]

One would expect both the junior and the senior tranche of a bond issued by a highly-rated country to be deemed safe. But generally speaking, countries with a poorer rating, too, could see their senior tranches rated as safer bonds and receive a better ranking for them than for their present, untranched bonds. Accordingly, a larger volume of highly rated government bonds could be made available by more countries[10] – bonds which banks would need to back with less capital if the necessary banking and financial market regulation were executed. The government default risk would generally be concentrated in the junior tranches. One effect of regulation could then be that the risky junior tranches are distributed to those areas of the financial system which are better able to absorb any losses or are less interconnected with other financial market participants. The pressure on monetary policymakers to also accept sovereign bonds of poor credit quality as collateral for refinancing operations or as part of an asset purchase programme could subside as a result.

The specific pros and cons would have to be examined in greater detail, as they would with regard to the ESBies proposal, too. The effects on sovereign borrowing costs would also need to be looked at more closely. Generally speaking, the tranching of national government bonds should not, in itself, have any major impact on the probability of default or on risk premiums. As the bonds would first be issued as a single entity (as is the case with bonds at present), a change in the individual countries' financing conditions would be unlikely – all other things being equal – solely as a result of the proposed tranching. But the yield spread between the junior and the senior tranche would probably be greater, the higher the assessment of a sovereign's default risk. A country's risk premium could rise as a whole, however, if the tranching were accompanied by further adjustments to the bond terms and the governance framework of the EMU, and if investors consequently considered the overall possibility of a bail-out by other member countries or by means of monetary policy to be less likely. A higher risk premium would ultimately not pose a problem, though, if the sovereign solvency risk were adequately priced in by the market.[11]

GDP-linked bonds

To be able to better avert sovereign debt crises in future and to deal with them more effectively if they do occur, discussions are currently under way on issuing sovereign bonds with a coupon and/or a redemption amount that would be linked to growth of gross domestic product (GDP).[12] If the econ-

9 Accompanying reforms of, among other things, collective action clauses would be needed to ensure that a debt restructuring remains possible and, at the same time, that a haircut does not constitute an easy way for governments to be rid of their debt burden. From a legal perspective, it would need to be defined how, if debt restructuring negotiations became necessary, claims of a junior tranche would be represented when a junior tranche was no longer held along with the senior tranche.
10 See also M Brunnermeier et al (2016), The sovereign-bank diabolic loop and ESBies, American Economic Review: Papers & Proceedings, 106(5), pp 508-512.
11 The proposed tranching would lead to a lower volume of individual tranches than in the case of an untranched bond, which is why the new bond structure could result in a certain increase in liquidity premiums. Yet given the similarity of the bond yields of member countries with very different issue volumes in the run-up to the crisis, such an increase could prove to be rather insignificant.
12 For further details see, for example, O Blanchard, P Mauro and J Acalin, The case for growth-indexed bonds in advanced economies today, Policy Brief 16-2, Peterson Institute for International Economics, February 2016; and D Barr, O Bush and A Pienkowski, GDP-linked bonds and sovereign default, Bank of England, Working Paper No 484, January 2014.

omy as a whole were to perform better than had been forecast when the bond was issued, this would benefit the holders of GDP-linked bonds. On the other hand, if there were an unexpected, less favourable development, lower payment obligations would take pressure off the country's finances. In this way, the risks and opportunities presented by uncertain economic developments would, to an extent, be shifted away from public finances to the private sector. For advocates of GDP-linked bonds, this holds the promise of strengthening the resilience of public finances against negative shocks. This could serve to reduce the risk of a sovereign debt crisis involving high macroeconomic costs, and leave greater fiscal policy leeway to deal with a negative shock. In particular, this would be the case if the sovereign bonds were widely distributed internationally, meaning that the burdens caused by a negative shock would be spread globally, too.

Moreover, GDP-linked bonds could be used in the event of a debt restructuring.[13] Given that growth prospects are particularly uncertain in such a situation, these bonds could help to facilitate an agreement between the debtor country and its creditors and in limiting the danger of having to repeat a restructuring procedure. Ultimately, the deleveraging would be greater if developments proved to be less favourable than anticipated in the baseline scenario underlying a sovereign debt restructuring. Conversely, it would be lower if developments were more favourable.

In this context, the impacts of GDP-indexed bonds would largely hinge on the specific bond design, and no standardised instrument has been developed thus far.[14] Before they could be widely introduced as a regular financing instrument, the drawbacks they would entail would likewise have to be examined more closely and weighed up against the advantages. For instance, GDP-linked bonds could help reduce the danger of a sovereign losing access to capital markets, and blunt any need for short-term procyclical consolidation measures. On the other hand, risks would be shifted to the private sector that could also affect financial stability and macroeconomic developments. One point that is likely to be crucial is whether GDP-linked bonds are primarily held domestically or abroad, and how negative global shocks in the financial system would be dealt with. If GDP-linked bonds were mainly held by domestic players, less of a smoothing effect on the economy as well as on the robustness of public finances would be expected overall. However, a fundamentally stable financial system would be a prerequisite for introducing GDP-linked bonds to ensure that the unexpected fluctuations in the instrument's value and payments can be absorbed by the creditors in such a way that they do not exacerbate or even trigger a systemic financial crisis. Otherwise, there is a danger that the risks ultimately have to be shouldered by the state (or community of states) again after all. Another danger could be that the desired relief would only come after a time lag pending more reliable data on economic developments. Nor can the basic uncertainties involved in objectively calculating GDP be dismissed out of hand; moreover, it would have to be ensured that the data are transparent and largely protected against manipulation. On the whole, the ef-

13 For example, GDP-indexed bonds were issued when Greece's debt was restructured in 2012. See, for example, J Zettelmeyer, C Trebesch and M Gulati, The Greek debt restructuring: an autopsy, Economic Policy 28(75), pp 513-563.
14 At the initiative of the Bank of England, work is currently under way, with the collaboration of market participants, to design a standardised instrument known as the London term sheet. See Allen & Overy LLP, Indicative term sheet – GDP bonds, 30 November 2015.

fect of GDP-indexed bonds would probably also depend on the maturity structure: the shorter the maturity of the outstanding bonds, the less relief likely to be experienced by the government budget in the event of adverse developments, as its impact would only last until the maturity of the respective bond. Investors' yield demands with regard to new issues would likely be adjusted to the revised growth forecasts.

Essentially, sovereign borrowing costs would probably rise if such bonds were introduced, because risks would be passed through to the private sector. Investors would demand compensation if the risks under a GDP-linked bond were not negatively correlated with the risk profile of their remaining portfolio. If the resilience of public finances to negative shocks were strengthened, however, at least the default-related part of the risk premiums could decrease as a result.

see, for example, the chart on p 60). To enhance credibility, the individual steps could be incorporated into the ESM Treaty. The aim of entrusting the tasks to the ESM would be to ensure that the otherwise loose elements of a debt restructuring are effectively coordinated.

National sovereignty and need to fulfil sovereign tasks must be taken into account

The restructuring of sovereign debt differs in a number of ways from a private corporate insolvency. For instance, the primary objective cannot be to liquidate the available assets.[26] Rather, the goal is to restore a sustainable financial situation as quickly and on as durable a basis as possible – including a sound macroeconomic perspective – not least in order to be able to service the remaining debts. This should be ensured, in particular, through the adjustment programme that is to be agreed in such a situation and which should include both the ESM assistance and a debt restructuring. In this context, the member state's national responsibility must be observed and it cannot be forced to implement debt restructuring. This would be in conflict with the principles of constitutional sovereignty and democratic self-determination. A restructuring coordinator is therefore not able to make an autonomous decision about a debt restructuring, but merely supports an orderly process and the search for compromise. The debtor country must ultimately play its part in the agreed procedure. Finally, a debt restructuring requires the agreement of the creditors – in line with the pre-defined majorities. However, this is only likely to come about if the member state credibly indicates that it will rigorously implement the necessary reform measures. It thus remains the case that any measures would hinge on cooperation between the

26 Moreover, the value of sovereign assets is uncertain, not least in a crisis situation, and assets can only be liquidated to a limited extent.

member states and the creditors.[27] In this context, the ESM's goal should be to reconcile the interests of all the parties and support a rapid restoration of the sovereign's ability to pay without pushing for a premature or excessive haircut.[28]

ESM could produce sustainability analysis and record claims

In this context, thought could be given to fundamentally strengthening the role of the ESM. When a member state requests financial assistance from the ESM, the assessment of further economic developments, debt sustainability and financial requirements are currently drawn up by the European Commission in liaison with the ECB, and this is also envisaged for the monitoring of economic policy conditions. These tasks could in future be transferred to the ESM, or the latter could take the leading role in the process. To this end, the comprehensive information on the country's current situation would have to be submitted to the ESM along with the request for financial assistance and subsequently checked. At the same time, when drawing up an assistance programme, the sovereign exposures would also need to be recorded by a central body. This task could likewise be assigned to the ESM. However, this new strand of work, which would need to be specified in advance, would only become relevant if a member state is found to be overindebted. To this end, creditors of bonds and credit obligations could be asked to register their claims as a precautionary measure when the request is submitted.[29] The ESM could subsequently check the claims and, where appropriate, rank them according to different servicing categories to ensure that verified claims in the same group can be given equal treatment during the debt restructuring negotiations.[30]

Agreement on adjustment and debt restructuring plan requires appropriate reconciliation of interests

If the ESM decides as part of the debt sustainability analyses that a debt restructuring is a necessary prerequisite for an adjustment programme or the continuation thereof, this assessment should serve as a starting point for the negotiations on how to distribute the adjustment burdens. During the exploratory talks and negotiations, the interests of the debtor state and claimants should be reconciled; this will then facilitate an agreement on a reform programme and a debt restructuring plan. In this context, there must be a sharing of burdens between fiscal and structural measures, for which the member state is responsible at a national level, on the one hand and reducing the debt burden on the other hand. To ensure that claimants are treated equally, in addition to the verified claims arising from sovereign bonds, claims from creditors arising from credit obligations should also be included in the negotiations. This should minimise the risk of coordination problems and the opportunistic be-

27 To ensure that negotiations on debt restructuring do not start too late, an automatic debt restructuring was also discussed (sovereign CoCos). This should be triggered automatically if the thresholds for fiscal stress indicators – such as a certain debt ratio – are breached, and could, for instance, be set solely for any debt in excess of the reference values for the Stability and Growth Pact (accountability bonds). See, for example, A Mody, Sovereign debt and its restructuring framework in the Eurozone, Oxford Review of Economic Policy, Volume 29(4), pp 715-744; and C Fuest, F Heinemann and C Schröder, Reformen für mehr fiskalische Eigenverantwortung der Euro-Staaten: Das Potenzial von Accountability Bonds, study for the Bavarian Business Association (Vereinigung der bayerischen Wirtschaft, vbw), forthcoming. However, such automatic triggers over and above a maturity extension present considerable problems in terms of selecting suitable indicators for debt sustainability (eg with regard to country-specific characteristics, economic content, misguided incentives, transparency, audit compliance and manipulation resistance) and, moreover, particularly as a result of there being no obligation to implement reforms. Here, too, the onus is ultimately on the member state concerned to comply with the agreements that were previously reached.

28 Owing to an automatic maturity extension in bond contracts, the ESM would in future play only a relatively minor role as creditor of the member states concerned and would therefore have less of an interest in the member state being relieved too easily at the expense of the creditors. This could potentially increase the risk premiums of the other member states.

29 This also includes claims arising from purchases of bonds by other member states, the Eurosystem or claims of other multilateral institutions. Otherwise, the equal treatment would be in jeopardy, private creditors might be less inclined to consent and the fragmentation of debt restructuring negotiations would probably unnecessarily hamper the process. In the case of IMF claims arising from balance of payments assistance to a country, the IMF would, as it has up to now, have preferred creditor status.

30 If claims are not contested by the debtor country or other creditors, these could be deemed to have been verified. The clarification of any disputed issues could initially be supported by the ESM before the parties take legal action.

haviour of individual creditors preventing an orderly debt restructuring.

National responsibility necessitates possibility of ruling out financial assistance

The member state's individual responsibility plays a particularly important role when drawing up an adjustment programme and debt restructuring plan that permit compromise. In addition to the typical consolidation measures and potentially improving debt sustainability through privatisations, a one-off capital levy could also be considered when assessing debt sustainability and deciding how to reconcile the interests of the parties.[31] This would be in line with the principle of the member states' individual responsibility that is anchored in the governance framework of the EMU, because responsibility for and the making of fiscal policy decisions lies at the national level. Thus, unsound developments must also primarily be corrected through own funds. However, as stated above, the decisions on the national distribution of adjustment burdens and thus the specific measures should finally be made and implemented by the member state concerned. But, ultimately, the ESM must then have the option of recommending that the Board of Governors rejects a request for financial assistance, particularly if the member state concerned does not make sufficient efforts and can thus rather be judged to be unwilling to repay its debts.[32] This would result in a less orderly procedure in which the ESM does not play a role.

ESM financial assistance can facilitate agreement by private creditors to necessary debt restructuring

The agreed adjustment programme should support sustainable economic developments and make it highly likely that the member state's ability to repay its debts will be restored. If combined with the supplementary deployment of financial assistance, private creditors might also be more inclined to agree to a necessary haircut. The implementation of the programme could likewise be monitored by the ESM in future.

However, an adjustment programme's success – with or without debt restructuring – ultimately cannot be guaranteed even if all the measures are implemented in full. It therefore cannot be ruled out that the member state concerned is not able to return to the capital markets when the programme ends without restoring debt sustainability. In this case, (renewed) debt restructuring negotiations might be required. These would then also include those claims that have already been automatically extended or were reduced during a previous debt restructuring.[33] Furthermore, it cannot be ruled out that no agreement is reached on an adjustment programme or that a member state ceases to service its debt without requesting financial assistance. This would presumably be the least favourable option for all parties. For the euro area, it is nevertheless important that financial stability is strengthened in future so that it is also safeguarded if such a scenario with potentially somewhat unorderly debt restructuring negotiations occurs.[34]

With no access to capital markets, threat of (further) debt restructuring at end of programme

Impact on financing costs unclear

Agreement on a credible restructuring procedure could result in market participants considering there to be a generally higher likelihood of debt restructuring occurring in future. However, it is not clear what impact this will have

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31 The prospect of a one-off capital levy in the event of a crisis could potentially also counter incentives for unsound fiscal policy, which might otherwise arise from the member state's expectation that it will later be able to rid itself of its sovereign debt burden in a supposedly easy way at the expense of the creditors (or the other member states). For more information, see Deutsche Bundesbank, A one-off capital levy: a suitable instrument for solving national solvency crises within the current EMU framework?, Monthly Report, January 2014, pp 49-51; and G Kempkes and N Stähler, A one-off wealth levy? Assessing the pros and cons and the importance of credibility, Fiscal Studies, forthcoming.

32 The Board of Governors is the ESM's political decision-making body. It is composed of the member states' government representatives responsible for finance, each of whom nominates a member of the Board of Directors as well as the ESM Managing Director. If the ESM proposes granting financial assistance, the Board of Governors must agree to this in order to ensure the necessary democratic legitimacy of the associated assumption of default risks by other member states.

33 Before providing any financial assistance under a follow-up programme, it would have to be ensured that the maturity of the restructured debt securities runs for the planned duration of the programme so that the ESM continues to finance outstanding deficits but not any redemption payments to private creditors.

34 See Deutsche Bundesbank, Approaches to strengthening the regulatory framework of European monetary union, op cit.

Outline of a reformed procedure for resolving sovereign debt crises in the euro area

The article weighs up a range of reform measures aimed at resolving the financing problems of euro-area member states. To this end, this box presents a possible plan for such a procedure, based on some of the reform approaches described.[1] The respective timeframes, in particular, can be set differently. As explained in the main text, the prerequisite for any such procedure would be a prior reform of the bond terms and of the Treaty establishing the European Stability Mechanism (ESM).

Triggering the procedure and next steps

As in the past, if a member state encounters major financing difficulties, the crisis resolution procedure would be triggered by the member state submitting a request for financial assistance to the ESM. Government bonds receive an automatic maturity extension once an ESM programme is in place, based on the assumption of an upfront reform of the bond terms; thus, the maturities of the outstanding bonds would be extended under the agreed conditions. The request would initially facilitate an extension of, for example, ten weeks, prior to a final decision being taken regarding the programme. During this period, the ESM would conduct an initial stock-taking, on the basis of which an adjustment programme would be negotiated (within the set time) and an agreement reached regarding any restructuring that may be necessary, the latter to be negotiated with creditors. In addition, the ESM's Board of Governors would need to approve any potential financial assistance. Therefore, until a final decision has been made regarding the programme, no funding requirements arise due to redemptions.[2] Nevertheless, the financing of deficits might be necessary. Any temporary assistance to cover acute financing needs above and beyond that would need to be made subject to special collateralisation requirements and, like regular financial aid, would be excluded from any debt restructuring.

Initial stock-taking

In concrete terms, upon a request being submitted by the member state, all the relevant information would need to be presented at that juncture in order to work out an aid programme. An initial stock-taking would be conducted within a fixed period of, say, four weeks from the date of submitting the request. To this end, an analysis would be compiled of the macroeconomic and fiscal situation and of the perspectives, in particular with respect to the sustainability of the public finances and thus to any debt restructuring deemed necessary. The possible courses of action would also be drawn up.

The tasks performed by the ESM, which would also be responsible for overall coordination, would take the form of two simultaneous strands of work. The first of these would consist in the ESM preparing a projection of the macroeconomic and fiscal development for the member state and a forecast of that country's expected financing needs amid a no-policy-change scenario.[3] At the same time, the ESM would draw up a "programme scenario" under which the member state would be obliged

1 The procedure outlined here would gain in importance with every new issue of a bond with the reformed bond terms. However, it does not offer a direct solution to problems posed by the, in some instances, very extensive ongoing liabilities of member states not subject to an automatic maturity extension or (aggregate) collective action clauses. As such, nor does it provide a direct solution to the difficulties involved in a possible restructuring during the transition period.
2 Ideally, the member state should not submit a request a very short time before a due date that it is unable to comply with.
3 In principle, the ESM could be supported in this task by the European Commission in liaison with the European Central Bank and, where appropriate and possible, the International Monetary Fund (IMF).

(in keeping with the subsidiarity principle) to specify reforms and measures that it would implement under its own national responsibility to consolidate its budgets and improve the conditions for macroeconomic development. These scenarios provide the basis for the ESM's assessment of the sustainability of public finances and thus also its quantification of any restructuring needs upon completion of the initial stock-taking.

The ESM's second strand of work would involve taking precautionary steps to quantify claims on the member state arising from outstanding bonds and credit obligations, should it become necessary to conduct debt restructuring. As an integral part of the stock-taking, the member state would be required to supply the ESM with an overview of all eligible claims. In this context, the ESM could function as a central point of contact for creditor claims.[4] Upon activation of the procedure, these creditors would be asked to present their claims on the state within a specified time period (eg two weeks), backed with eligible documentation.

Decision on assistance programme and possible restructuring

The initial stock-taking would be followed by negotiations to specify reforms and measures. To accommodate these, a second fixed timeframe of, for example, four weeks could be set.[5]

Scenario involving a temporary liquidity problem

As a general rule, it is virtually impossible to reliably distinguish between a temporary liquidity problem and sustainability difficulties from the outset. Where the problem is probably of a temporary nature and thus rectifiable by means of an adjustment programme, the approach would not change much under an ESM programme, in which case the adjustment programme would be substantiated following completion of the stock-taking. Where alterations to the drafted programme scenario seem necessary, any concrete reforms and measures should, in turn, be proposed by the member state concerned, while the ESM would determine the scope of whatever financial aid was deemed necessary, as in the past. The final adjustment programme would be determined in accordance with the ESM's decision-making process. Upon the programme's inception, the maturity extension stipulated in the bond contracts would result in maturities automatically being extended by three years. Thus, without triggering a credit event (and the attendant potential distortions in the financial markets), investors would remain liable for their investment decisions over a longer timeframe, and recourse to ESM funds would be limited. Implementation of the programme would be subject to ongoing monitoring by the ESM, and financial assistance would be paid out contingent on the implementation of the agreed measures.

Scenario involving a sustainability problem

In the course of the initial stock-taking, however, it could also turn out that the member state is unlikely to regain access to the capital market by the end of the programme's duration, even if the measures contained in the programme scenario are fully implemented, indicating that the problem is not a liquidity shortage but an issue of sustainability. In this case, a debt restructuring would have to be negotiated with the creditors within the stipulated second timeframe of four weeks (in parallel to the finalisation of the adjustment programme) as a prerequisite for ESM financial assistance. This would entail convening an initial

4 As an alternative, this task could be handled by a separate body that would present the information to the ESM for further processing.
5 If the ESM concludes that the member state's request for financial assistance is basically unwarranted because the country concerned could overcome its difficulties through its own efforts, the Board of Governors should be advised to reject the request.

meeting of all claimants at the beginning of the second four-week period. At this meeting, the ESM would present the provisionally advised adjustment programme and specify the ensuing need for a debt restructuring. On this basis, the specifics of distributing the adjustment burdens by way of reforms and potential losses for creditors as part of a debt restructuring would be negotiated. Here, too, the national distribution of the burden would have to be proposed autonomously by the member state in question.[6]

During the restructuring negotiations, the ESM would classify the claims according to any ranking that may exist for servicing purposes, explore the different views, manage the negotiations and seek to ensure that the interests of the parties concerned are reconciled.[7] At the end of the second four-week period, another bondholder meeting would be convened and the specific restructuring plan that had been negotiated would be presented for voting.[8]

If the debtor country cannot reach an agreement with its creditors at the deciding meeting, a further period of two weeks, for example, could be set in which to come up with a last compromise proposal.[9] In the final vote, the (aggregated) majority requirement could have been reduced by a corresponding clause in the bond contracts.[10] If no agreement is reached, the ESM would have to recommend that the Board of Governors reject the request for financial assistance. Accompanying reforms to the governance framework of monetary union, implemented prior to this, would have to be designed in a way to ensure that a sovereign default outside an ESM programme is manageable in future for financial stability in the euro area.[11] Regardless of this, neither the country in question nor its creditors are likely to have an interest in such a development.

If, however, the parties concerned manage to agree on a debt restructuring and an adjustment programme at the final vote at the latest, the agreed conditionalities would be set with the country in question and, together with a proposal for the granting of financial assistance, be presented to the Board of Governors for the final decision. The restructuring would be conducted in parallel to this. The programme's progress would then be monitored by the ESM on an ongoing basis and, as before, the financial assistance would be paid out contingent on the implementation of the agreed measures.

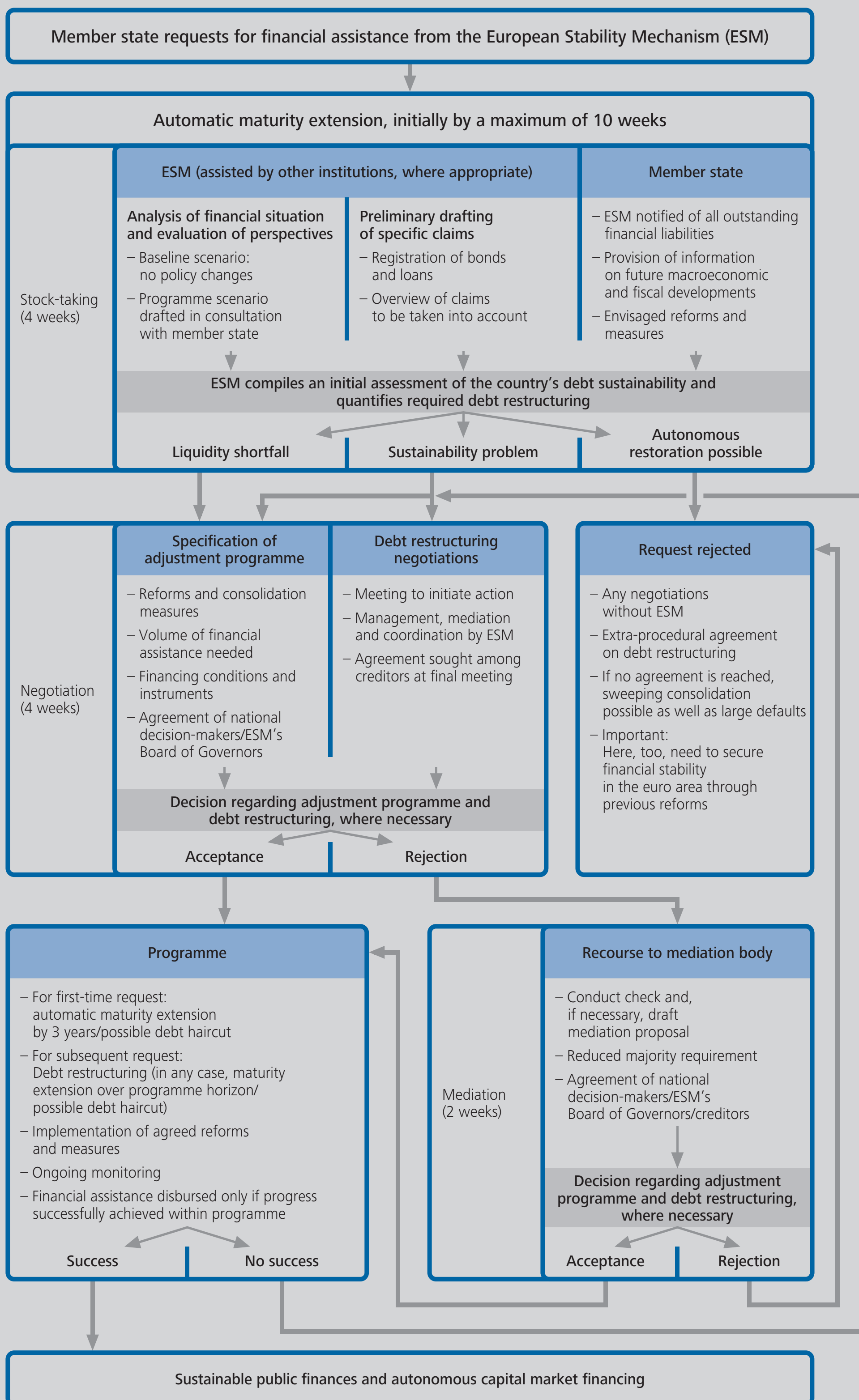
Course and end of the programme

If the programme runs as expected, the country could regain access to the capital market by the end of the programme – if not before – and, going forward, be able to service the liquidity assistance granted as well as private creditors' debt securities falling due.

Even if all the agreed fiscal and structural reforms are implemented in full, however, it is uncertain whether an adjustment programme will succeed – regardless of

6 In the case of overindebtedness, drawing on the private net wealth of citizens for a one-off extraordinary capital levy would be an option in principle, in addition to permanent consolidation measures and privatisations.
7 Any credit claims held by the IMF or ESM enjoy preferred creditor status.
8 For bonds with (reformed) collective action clauses, restructuring requires a qualified majority of creditors.
9 Under certain circumstances, the establishment of a "mediation committee", which should be independent to the greatest degree possible, could also be considered. The European Court of Justice, for instance, could assume this role.
10 For example, in the case of a bondholder meeting, the required majority could be reduced from 75% to 50% of the principal amount present, given the same quorum of 66⅔% of the outstanding principal amount of the affected debt securities or, in the case of a written resolution, from 66⅔% to 50% of the affected debt securities. Such a rule would be planned into the fundamental reform of collective action clauses which, like the proposed reform of the bond terms, is a prerequisite for the procedure described here.
11 See Deutsche Bundesbank, Approaches to strengthening the regulatory framework of European monetary union, Monthly Report, March 2015, pp 15-37.

Potential steps of a reformed procedure for resolving sovereign debt crises in the euro area



Deutsche Bundesbank

whether or not it involves a debt restructuring. There is thus no way to rule out that the need for a (further) restructuring only becomes apparent during or at the end of an adjustment programme. If the debt sustainability and capital market access of the country in question were not restored by the end of the programme's duration, despite the agreed measures being implemented in full, (renewed) restructuring negotiations would be the only way forward. These should likewise be conducted according to a standardised process in order to establish sustainable public finances in line with the agreed procedure and within the set time period given as an example. This process would also include those claims that were already extended under the adjustment programme or that had already suffered losses during a previous restructuring. If, during this process, the ESM negotiates a new adjustment programme for which it proposes financial assistance, it would have to be ensured that, in the restructuring, the outstanding debt securities are substituted such that their maturities exceed the estimated programme duration, and the creditors thus remain liable. If a liquidity problem is identified once more, a maturity extension could be deemed sufficient. Only then, at the latest, would the action no longer constitute an extension agreed in the bond terms, but a restructuring. If no agreement were reached, the ESM would have to recommend that the Board of Governors reject the granting of additional financial assistance. Restructuring negotiations would then have to be conducted without the participation of the ESM.

on the risk premiums of the member states. An orderly procedure reduces the uncertainties for investors in terms of the necessary steps and the intervening period until fundamental sustainability has been restored, and curbs the costs of the coordination problems. This should make a more reliable calculation of the risk of loss possible, and the proposed reforms should expedite the process as a whole, thereby reducing the economic costs of an overindebted government and thus, as a general tendency, any necessary haircut. If such a procedure were to result in an increase in risk premiums, for instance if a bail-out by the other member states were deemed less likely after such a reform had been introduced, this would have to be viewed as a correction of previously distorted market pricing, as such a bail-out is not envisaged under the existing framework of the EMU. This would, in turn, counteract excessive debt accumulation and prevent costs potentially being passed on to other member states. If this were to lead to sounder public finances overall, lower risk premiums could even be expected in future.

Conclusion

Reforms must enhance governance framework and financial stability

No fundamental changes have been made to the governance framework of the EMU since the outbreak of the financial and sovereign debt crisis, but the current framework remains in need of reform. In this context, there seems to be a lack of consensus for further developing the EMU into a real fiscal or political union. Therefore, the EMU should be further developed within its originally agreed framework. Safeguarding financial stability plays a key role in this context, particularly with regard to the negative interplay between sovereigns and financial institutions.

Adjustments to bond terms facilitate future crisis resolution

Changes in the terms of the member states' sovereign bonds could make an important contribution, particularly with regard to tackling

future sovereign debt crises. An automatic maturity extension if financial assistance is granted by the ESM and a single-limb majority requirement for debt restructuring could be included in the bond terms. This could alleviate the problem of diagnosing acute government financing problems, strengthen investors' individual responsibility, boost the clout of the ESM and curb the transfer of risk to the other member states, which, in turn, could facilitate an agreement on any debt restructuring.

Rule-bound procedure could strengthen crisis mechanism

If it is agreed in advance how to proceed in the event of a debt restructuring – and particularly if this is linked to the proposed changes to the bond terms – this could expedite the process and make it more predictable. In this context, the coordination and associated tasks, such as recording the existing claims, could be given to the ESM and, if there is a vote in favour of debt restructuring, the latter could also be tasked with an adjustment programme and ESM financial assistance. If the crisis resolution mechanism is strengthened, it could furthermore also be considered whether, over and above this, the ESM should be assigned the function of an independent fiscal authority. The tasks of assessing budgetary developments and compliance with the fiscal rules, which have up to now been the remit of the European Commission, could be transferred to this fiscal authority. Overall, the cost and level of any future haircut could thus be reduced. However, since under the existing governance framework of the EMU the decision-making powers for financial and economic policy continue to lie with the member states, even once a debt restructuring procedure has been set up, its success would crucially hinge on the member states' willingness to pay and cooperate.

Gradual entry into force of individual elements avoids abrupt market reaction and enhances the procedure

The proposed reforms could consequently help to strengthen the no-bail-out principle in the euro area and the member states' individual responsibility, and thus also render future sovereign debt crises less likely. The key elements would be implemented gradually, rather than on an *ad hoc* basis, by adjusting the bond contracts of new issues. This would strengthen the crisis resolution mechanism outlined above. However, this mechanism does not present a direct or simple solution for the member states' – in some cases – still very high sovereign debt, and the problems of a possible need for debt restructuring during the transitional period would also only be alleviated gradually. Overall, the member states should therefore use the time available to implement the consolidation course that has already been agreed and make their public finances more crisis-resilient. At the same time, it is crucial to introduce reforms aimed at increasing financial market stability, which not least break the nexus between national government finances and the banking system while making the restructuring of sovereign bonds a viable option.

European Stability and Growth Pact: individual reform options

Sound public finances are of crucial importance for a stability-oriented monetary union. This should therefore be what the European budget rules aim to achieve. The rules have been amended on numerous occasions, and changes are currently once again under discussion.

Any reform should uphold the fundamental objectives of the budget rules. If the medium-term objectives (or MTOs) are achieved rapidly and maintained, the debt ratios will drop quickly from a high level. In order to render the quantitative targets more binding again, however, the rules have to be designed more transparently and implemented predictably. Therefore, large numbers of exceptions and scope for discretion should be dispensed with. Strict fiscal surveillance is also important. To this end, it would make sense to transfer the European Commission's tasks to an independent, less political institution with its focus on monitoring compliance with the rules.

Various other adjustments are currently also being discussed. These include a stronger focus on expenditure ceilings. This could streamline the rules in various places. However, expenditure rules are also difficult in practice, and they open up new loopholes. This would have to be taken into account when designing the rules. In any event, expenditure ceilings should take the existing structural fiscal objectives as their frame of reference. In addition, they should be specified only for the next financial year, and not for a number of years.

A frequent complaint is that strict quantitative requirements are too narrow. In order to have a buffer even where limits are strict, national rainy day funds could be created and utilised. It should be possible to fund them in advance to the amount by which the MTO is overachieved. This would help prevent undesirable additional borrowing. It would be advisable to use such buffers only in a rule-based manner to cover unexpected burdens. Proposals for a relatively complicated rainy day fund at the European level do not make a convincing case, however. It is difficult to reconcile its joint financing with continued national responsibility for fiscal policy. Key objectives being pursued with European funds could also be achieved through national funds.

Frequent calls are made, moreover, for a "golden rule" to protect public investment. The problems associated with such an approach became evident, for instance, with the previous German budget rule, which was replaced with good reason. If a golden rule were nevertheless considered for the European rules, the associated risks, at least, should be minimised. Thus, investment should not justify unlimited additional deficits. No compromises should be made regarding the objective of rapidly declining high debt ratios, meaning that the MTO should be relaxed, if at all, only if the debt ratio is significantly below 60%. Also, the definition of investment should be narrow and harmonised. Moreover, only the build-up of additional assets should be encompassed, while capital depletion (negative net investment) would call for more ambitious fiscal positions.

Credible and binding fiscal rules help to limit the risks to stability and build confidence. However, their success will ultimately be determined by the Member States, which are responsible for fiscal policy. It is therefore vital that they raise their own funding on the capital market and are compelled to present a convincing fiscal policy stance there.

Debate on the Stability and Growth Pact

Sound public finances safeguard monetary policy

Sound public finances are important for the stability of the monetary union. They ensure that the Member States are capable of fiscal policy action and safeguard a stability-oriented monetary policy. Monetary policy could come under pressure to assist fiscal policy if confidence in sound public finances is lost.

Member States responsible for their fiscal policy

Within the monetary union, Member States decide their own fiscal policy. The currently very low interest rates make it easier for them to shoulder their debt.[1] However, high debt levels remain a risk to the stability of the monetary union.[2] It would be risky to view the currently very low interest rates as permanent and therefore to pursue a strategy of high government debt levels. Rising interest rates might then quickly erode confidence in the soundness of public finances, with adverse effects on the Member State and the monetary union.

Individually liable financing important

Jointly agreed fiscal rules should set binding limits and create confidence in the sustainability of public finances. However, the fiscal rules can fulfil their purpose only if countries adhere to them. The European level cannot determine Member States' fiscal policy in order to enforce compliance with the rules. It is therefore vital that Member States raise their own funding on the capital market and are compelled to present a convincing fiscal policy stance there. Potential risk premia are a strong incentive for fiscal discipline.

Reform discussion should be guided by existing quantitative budget ceilings

Over time, the fiscal rules have been repeatedly modified, and reforms are currently being debated again. The aim should be to design the rules such that high debt ratios are brought down swiftly and a sound underlying position is achieved. And, indeed, the existing agreements do reflect this intention: the key objective is for the general government budget to be at least (close to) balanced in structural terms – in other words, after adjustment for cyclical and one-off effects. This is known as the medium-term objective or MTO. Where debt ratios are higher, the MTO should not exceed -0.5% of gross domestic product (GDP). If this MTO is met, debt ratios will usually also decline rapidly. Only if the debt ratio is significantly below 60% may a less ambitious MTO be set. If Member States fail to meet their MTO, the rule is that they should generally lower their structural deficit ratio by 0.5 percentage point per year. By doing so, they would in most cases deviate from their budgetary objective for no more than a limited transitional period.[3]

Fiscal rules are currently poorly designed and implemented

At present, however, the common rules often allow deviations from these basic quantitative requirements. The aim should be to strengthen the rules again. Although a certain degree of flexibility in the budget rules is appropriate and some measure of complexity is therefore unavoidable, the rules and their implementation still have to be transparent and predictable. This is becoming less and less the case with the European rules. Their application is the result of a process of political negotiation, and instead of binding quantitative rules, there are moving targets. Wide areas of scope for discretion mean that it is possible to excuse even persistent gross failure to achieve the targets. It is, for instance, evidently possible to delay the reduction of even very high debt ratios again and again, while still remaining within the rules. In the meantime, neither the general public, nor politicians, nor academics can determine where the boundaries of a rule-consistent budgetary policy lie. Changes are necessary to reinforce the rules.[4]

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1 See Deutsche Bundesbank (2017a); Blanchard (2019).
2 See ECB (2016), p. 59; Fuest and Gros (2019a).
3 In addition to the MTO, there is the reference value of 3% of GDP for the (unadjusted) deficit and a figure of 60% for the debt ratio. These define the limit for what is known as the corrective arm of the Stability and Growth Pact (SGP), which will not be discussed in greater detail here. For information on the rules, see European Commission (2017a, 2019); Regulation (EU) 1175/2011; Council Regulation (EU) 1177/2011; Regulation (EU) 473/2013; OJ 2010 C83/99; OJ 2010 C83/279; Treaty (2012).
4 For more information on the tasks and a criticism of the European fiscal rules, see also Deutsche Bundesbank (2017b).

Discussion on more budgetary leeway

Yet strict rules are also criticised for being too restrictive. The argument is that they allow too little room for macroeconomic stabilisation and government investment. However, the rules do allow some leeway in this context. For instance, the rules are designed to ensure that automatic stabilisers can operate. In addition, exceptions are made for severe downturns. Leeway is also available where safety margins vis-à-vis the normal limits were established. Nor do the rules prevent the provision of an efficient public infrastructure. Shortcomings there are, in fact, more often the result of political priorities being set differently.

Taking on board criticisms without compromising the objective of sound finances

The underlying quantitative objectives of the European budget rules are reasonable and appropriate. They safeguard sound government finances and allow sufficient room for manoeuvre. In that respect, they do not require an overhaul. Nonetheless, adjustments in individual areas could be examined without compromising the objective of sound public finances. The following areas will be looked at more closely: transferring fiscal surveillance to an independent institution, making the rules more transparent and more binding, introducing an expenditure rule, using control accounts and rainy day funds and, finally, the question of the extent to which a special role could be given to government investment.

Selected reform areas

Transferring fiscal surveillance to an independent institution

Independent fiscal surveillance advisable

Limits are only effective if compliance is monitored and any breaches are reported and penalised. Independent bodies are better suited to monitoring than institutions which are themselves part of the political process. Policy decisions consistently give rise to strong incentives for excessive borrowing. The fiscal rules form a counterweight to such incentives, meaning that fiscal surveillance by bodies with close connections to the political sphere is disadvantageous.[5] Consequently, the Member States agreed, with the Fiscal Compact, to establish independent national fiscal councils for the national level.

Rules at the European level must also …

At the European level, by contrast, the European Commission is the key player in fiscal surveillance. However, the Commission sees itself as a political institution and has other tasks besides fiscal surveillance. It therefore weighs different policy objectives in the negotiation process with the Member States. The very high degree of flexibility and the wide scope for discretion, in particular, mean that there is a risk of the objectives of the fiscal rules receding into the background.

… be monitored in a focused and independent way

To offset this, it would make sense to transfer fiscal surveillance to an independent institution. The competent authority should have a clear and narrow mandate and should not, in particular, pursue conflicting objectives. It should monitor public finances and assess fiscal plans. Its tasks would be to flag up actual and imminent breaches of the rules, identify consolidation needs and recommend procedural steps and sanctions. Its leeway for discretion should be strictly limited. On the basis of this preparation, the Council would, as is currently the case, take the decisions (e.g. determining the existence of an excessive deficit). However, the preparatory work and submissions would be less political. One could, for example, consider transferring the task of surveillance to the European Stability Mechanism and enhancing its independence in this area.[6] By contrast, the recently established European Fiscal Board focuses on the fiscal stance of the euro area and has very close ties to the European Commission.[7]

5 See, for example, Beetsma and Debrun (2016); Feld (2018).
6 See Deutsche Bundesbank (2019).
7 See OJ 2015 L 282/37.

Making the rules more transparent and more binding

Effective fiscal surveillance through clear and binding rules

Fiscal rules should set concrete and transparent standards. This is the only way to ensure that fiscal developments are assessed and treated in a comparable manner over time and between Member States. The European rules do not meet these requirements.[8] Therefore, clear restrictions should be placed on possible ways of deviating from the basic quantitative objectives. This relates to exemptions to the rules, as these are often neither clearly defined nor coherently justified. It is also problematic that assessments are, in many instances, not rule-based and breaches are excused. The European Commission has very wide discretion and may give its approval even if quantitative requirements for all indicators are breached. The exceptions should be delimited strictly and clearly, and the relevant audit processes and components should be defined in advance.

Any expenditure rules should be valid for one year at most and be tied to structural objectives

Expenditure rules are under discussion

A frequent proposal is that expenditure ceilings should feature more prominently in the rules.[9] This could, in fact, simplify the rules in some cases. However, expenditure rules are not easy in practice, and they also open up new loopholes. This would have to be taken into consideration when designing the rules. It is key that the expenditure ceilings should be based on the underlying requirement in terms of the structural balance and should not undermine it. This is another reason why it is not advisable to determine expenditure targets for multiple years.

Objectives should continue to be defined as structural balances, …

Under the European rules, the MTO is defined as a structural balance. In addition, the amount by which the structural balance must be improved is specified if a country is on the adjustment path towards the MTO or must correct an excessive deficit. Structural balances (like all target variables for budget rules) have specific inherent problems. They are nonetheless sensible anchor points for budget rules and should therefore be retained. Structural goals, for instance, allow the automatic stabilisers to "breathe". At the same time, the fiscal stance can be identified from the structural balances.

… but they are subject to revisions …

However, it is not always possible to unerringly achieve concrete structural balances. They may reflect unexpected developments, for instance. This applies, in particular, to revenues, or it might relate to a revised estimate of aggregate economic output, on which cyclical adjustment is based. If no safety margins were incorporated, such forecast errors could cause structural balance objectives to be missed, even though the budget plans have otherwise been implemented as planned. Where structural balance targets are to be met despite unexpected developments, implementation of the budget would have to be adjusted on an ad hoc basis. This could trigger a rather erratic fiscal path. In order to avoid this and take due account of such unintentional failures to achieve targets, complex corrections and special assessments are carried out at present. As a result, even experts can often find it nearly impossible to identify why a requirement is considered as having been met or missed.

… and should therefore be put into operation using an expenditure rule

An expenditure rule could simplify this assessment process. For instance, corresponding maximum expenditure growth could be calculated for the structural balance to be achieved in the coming financial year.[10] This ceiling

8 A detailed and concrete description of the current rules' high degree of complexity and of starting points for simplification may be found in Deutsche Bundesbank (2017b).
9 Proposals for an expenditure rule may be found, for example, in European Commission (2017b); European Fiscal Board (2018), pp. 70-88; Bénassy-Quéré et al. (2018), pp. 10-12; Christofzik et al. (2018), pp. 13-21; Andrle et al. (2015), pp. 11-18; Darvas et al. (2018); Fuest and Gros (2019b).
10 A lot of proposals meanwhile envisage an expenditure rule that is not tied to a structural budgetary objective for the balance. The evaluation of such proposals will depend largely on what the setting of the expenditure ceiling is targeted at. In this, how quickly high debt ratios come down should be of particular importance. In many proposals, however, this remains indeterminate.

would then be the benchmark for assessing compliance with the rules in the year in question. Deviations in other categories or revisions of the cyclical adjustment would not be relevant but would be excused.

Expenditure rule not trivial

Nevertheless, an expenditure rule is not as simple as it seems at first sight. It is, for instance, likely to be difficult to implement and monitor such a rule in the individual government entities of a strongly decentralised or federal Member State. Moreover, the expenditure ceiling would have to be adjusted immediately if there were any measures on the revenue side: it would, for example, have to be reduced if taxes were subsequently lowered or subsectors of government with revenues and expenditure were to be spun off.[11] By contrast, subsequent tax increases could be used to fund additional expenditure.

Expenditure rule requires prudent forecasting

For the expenditure rule to be effective, it is essential that its limits be based on realistic forecasts. This is particularly true of profit-related taxes, which are especially hard to estimate, changes in tax legislation, and tax enforcement. If revenue forecasts were too high, the permissible expenditure growth would be set too high. The objectives for the structural balance would then be exceeded. In order to address false incentives, independent surveillance authorities should validate all forecasts and plans.

Expenditure ceiling should be laid down only for the coming year

Moreover, it would be important for the maximum expenditure growth to be determined annually, i.e. only for the coming financial year. For the following financial year, it would then have to be newly derived from the current, rule-compliant structural balance or from the required improvement in the structural balance. By contrast, there are also some proposals to set expenditure targets spanning a number of years, such as for one legislative period. This would be problematic, as it would potentially allow deficits to rise over this period without any countermeasures being taken. Economic activity being significantly weaker, in structural terms, than forecast might cause considerable problems over a period of several years, because the response to the new development would be much too late.[12]

Control accounts an important addition

Control account for missed targets …

Budget objectives may be missed for a variety of reasons. Revenue forecasts may have been too high or too low, for example, or spending may have been higher or lower than the authorised levels. This becomes critical when, as a result, debt increases over time more rapidly than the upper limits were designed to permit. It would therefore make sense to establish a control account for failures to achieve targets. This would record the amounts by which budget objectives have been exceeded or undershot.[13] At the same time, a threshold for negative deviations from the target should be established to indicate when the cumulative rise in debt needs to be corrected. If the amounts recorded more or less cancel each other out over time, there would be no need for action. However, if the threshold were to be exceeded, the accumulated shortfall would have to be offset, in a rules-based manner, in the next few years.[14] To this end, the requirements for the annual budget objective would

11 This would also be the case, for instance, if usage fees were to be reduced (or collected less consistently) or if there were a cut in specific transfers linked to expenditure, say from the EU.
12 However, it is sensible to continue to embed the annual budget in a medium-term plan, since corrective action is taken on an annual basis.
13 In principle, the amounts of both positive and negative deviations from the MTO could be recorded in the control account. Alternatively, before the MTO is reached, only deviations from the adjustment path could be recorded.
14 The main objective of the control account would be to prevent an unintentional build-up of debt. In principle, however, if entries are positive on balance and above a threshold, budgetary objectives could be made less ambitious for a while. That said, if this is at all possible, it should be on the basis of positive entries due to the MTO having previously been overachieved. By contrast, positive deviations from the adjustment path alone – i.e. if the MTO has not yet been met – should not be used to justify higher levels of new borrowing. Generally speaking, surplus funds from overachieving the MTO could also be used as a rainy day fund. This will be discussed in the following section.

have to be more ambitious for a certain period of time.[15]

… and cyclical components

There may be other reasons, too, for levels of debt being higher over time than is intended under the rules. This is especially true if the cyclical adjustment method is not symmetrical and shows negative output gaps on balance. This cannot be ruled out for the method which the European Commission applies to the European rules. As a control measure, the identified cyclical components could also be added up over time and any accumulated debt could be repaid.

Incorporating national rainy day funds into fiscal rules

Increase room for manoeuvre …

The quantitative requirements of the European fiscal rules are sometimes criticised for being too narrow. Critics argue, for instance, that Member States should avoid having to carry out procyclical consolidation in the event of an unexpected structural downturn. There are also calls for greater scope to be given to an active stabilisation policy, for example.

… without jeopardising debt reduction: creation of rainy day funds where MTO is exceeded

So as not to undermine the necessarily strict limits by making numerous exceptions, on the one hand, and to allow flexibility on the other, national rainy day funds could be utilised within the framework of the rules. The basic idea behind this type of fund is to build up a financial buffer in good times in order to prepare for "rainy days" ahead.[16] This concept could be added to the Stability and Growth Pact (SGP) without permitting additional debt. In other words, the targeted debt path under the MTO should, as a minimum, still be adhered to. Therefore, it should be possible to credit the fund only in the amount by which the MTO is overachieved.[17] This reserve could then allow room for manoeuvre. The limit of the regular MTO could be exceeded at a later date by drawing on these funds.[18] As a result, the regular MTO would not be met in every single year but on average from the time the rainy day fund is established.[19]

Rule-based utilisation of funds advisable

Such funds could, in principle, be used for different purposes. However, it would be highly advisable to stipulate provisions for the rule-based use of such funds in national legislation.[20] Otherwise, funds could create new problems. For instance, they might be used to generate "political business cycles". Moreover, large reserves might tempt policymakers to decide on permanent additional spending or tax cuts that are financed (only) temporarily from the fund. Structural difficulties would initially be masked and any need for consolidation would be shifted to future governments. In order to avoid this, it would be advisable to set out specific requirements for the use of the reserve in the medium-term fiscal plans. Therefore, the budget should be financed soundly and in full after the reserves have been used up. This would be ensured if the reserves were used to finance one-off expenses. This would also be the case if use of the buffers were tapered and had to be linked over time to specific matching fiscal consolidation measures. Provisions could also specify that the funds would, in general, be exclusively reserved for cushioning unexpected budgetary burdens. The aim of this would be to spread out any un-

15 As in Christofzik et al. (2018), pp. 18-19. For details on the debt brake, see Deutsche Bundesbank (2011, 2012); Federal Ministry of Finance (2015).
16 Almost all the US federal states have rainy day funds. See NASBO (2018).
17 The buffers in the rainy day fund do not necessarily involve a build-up of assets. It is more of a notional account that adds up the amount by which the MTO has been overachieved.
18 The control accounts described above could be introduced in parallel. At all events, only financial resources arising from overachieving the MTO should be added to the rainy day fund.
19 Government funds or reserves are unable to fulfil a similar purpose at present, since the MTO is fixed and the rules are linked to the public sector's national accounts balance. This balance is not altered by additions to or withdrawals from a government fund. Internal transactions such as these have a neutral effect on the balance. This means that higher expenditure or tax cuts have a detrimental effect on the balance even if they are financed from a government fund. Unlike in the EU rules, Germany's debt brake for central government is based on net borrowing (not on the fiscal balance). Therefore, with a view to net borrowing, the refugee reserve allows central government to apply a similar principle to that of a rainy day fund. It does not change the deficit as per the national accounts, however.
20 For detailed information, see Deutsche Bundesbank (2018), p. 32.

expected need for fiscal adjustment further using resources from the funds. Although the current rules already make allowances should the structural budgetary position take an unexpected turn for the worse during the fiscal year in progress, the structural deterioration would need to be addressed over the next few years. Drawing on the funds would then allow the adjustments to be spread over a longer period of time.

Rainy day funds: national rather than European

Calls are sometimes made for the introduction of a European rainy day fund, which would be jointly financed. Its proponents often stress that additional borrowing opportunities and transfers between Member States are to be ruled out.[21] However, the stated objectives of such a European fund could be achieved more effectively using national rainy day funds. For example, these do not require complicated "claw-back" mechanisms to avoid permanent transfers between Member States. In the current regulatory framework of the monetary union, national solutions generally appear more appropriate given that the Member States are responsible for their own fiscal policy.

Special protection for investment in budget rules?

Golden rule under debate

Debt-financed investment

In the debate about the budget rules, there are often also calls for borrowing to be allowed to finance government investment expenditure (known as the "golden rule").[22] The European fiscal rules make no provision for this.

Arguments in favour of a golden rule

On the one hand, supporters of a golden rule put forward the following arguments.

– Investment creates public assets. If additional assets are financed through borrowing, the debt level rises but the volume of net government assets remains unchanged. Seen in that light, the sustainability of public finances is not impaired, either.[23]

– Capital stock formed through government investment is a major prerequisite for macroeconomic growth. Investment funds itself insofar as future government revenue is higher.

– A golden rule would enable the investment costs to be distributed more appropriately between generations. It would improve the balance between the costs and benefits of the additional capital stock – financing it solely from current revenue would place the burden on today's taxpayers. Debt financing would allow the burden to be spread over a longer period corresponding to the assets' useful life.

– If borrowing is not permitted, there is a risk that investment and the government capital stock will be too low. For instance, investment tends to be supported by stakeholders who are less assertive than those calling for different expenditure or tax cuts. Politically speaking, investment is therefore fairly dispensable. If no final contractual agreement is in place, it is also relatively easy to curtail investment in practice (e.g. by postponing it). Should the need for consolidation arise, it is often the first thing to be reversed.

Arguments against a golden rule

Others, meanwhile, point out the problems associated with a golden rule.

– Replacement investment is likely to make up the vast majority of government investment

21 See Lenarčič and Korhonen (2018); Arnold et al. (2018).
22 See, for example, Blanchard and Giavazzi (2004); Truger (2015); Melyn et al. (2016); Hüther (2019). For the pros and cons of taking investment into account, see Deutsche Bundesbank (1999, 2005); Expert Commission (2016); European Commission (2016); International Monetary Fund (2018a, 2018b).
23 The European budgetary rules are based on the national accounts balance. Investment in financial assets does not affect the balance. It is considered to be purely a shifting of financial assets, and debt financing is therefore permitted. Such financial transactions include, say, loans issued or privatisation proceeds. However, there exists a limit for financial transactions through the provisions for the debt ratio (60%): if financial assets are acquired through additional borrowing, gross debt goes up. This is the main factor for the Maastricht debt level.

in advanced economies; this means that there is no increase, on balance, in the capital stock. Loan financing would be justifiable, if at all, only if the capital stock were to rise, however. This would mean having to take write-downs and other disposals into account.

– Problems can occur even if high levels of borrowing are balanced by a statistically high government capital stock. If there are doubts as to the sustainability of government debt, it is often very difficult to mobilise parts of the government capital stock in order to service the debt.[24]

– Whether or not government investment encourages growth depends on the specific investment projects. For example, net investment in what is already a very good infrastructure is likely to boost growth to only a very limited extent. Under these conditions, if there is any need for consolidation, it may well make sense to cut investment expenditure first. Ultimately, investment clauses in the budget rules are just as unsuitable as generalised targets for government investment ratios as a means of ensuring appropriate and efficient government investment.

– Credit financing as an easy option for policymakers could increase the risk of overinvestment and bad investments. Private investment might be crowded out, especially if aggregate capacity utilisation is high. There is also a danger that not enough effort would be made to check whether it would be better to obtain the corresponding service from private investors.

– Without further analysis, it is not possible to tell whether the costs and benefits of public investment are shared fairly between the generations. Preferences for individual investments can change, too, while the debt incurred in order to finance them has to be serviced under any circumstances. In addition, all other things being equal, a reduction or stagnation of the capital stock would seem reasonable given a decreasing population. A comprehensive review would ultimately be needed to evaluate the intergenerational distribution. For example, the pay-as-you-go statutory pension insurance scheme also has significant distributional effects in the context of demographic change. The golden rule does not take aspects such as these into account.

– There is a danger that, as a result of the golden rule, expenditure will be booked as investment where this was previously not the case. More generally, scope for bending and manipulating the rules would increase. The rules would also become more complex.

No golden rules at present

German debt brake a success thus far …

In Germany, central and state governments were subject to investment-related budgetary rules for many years. However, these proved ineffective[25] and were replaced by the debt brake.[26] Thus far, the debt brake has been successful in terms of reversing the decades-long trend of rising debt ratios. Although government budgets have benefited from very favourable underlying conditions, the new, strict budget limits are likely to have played a key role in ensuring that relief from sources such as

24 This applies, not least, to government investment in intellectual property.
25 In Germany, rule-consistent borrowing was limited to the level of investment expenditure. Investment grants received had to be deducted. This upper limit could be exceeded only in order to avert a disruption to overall economic equilibrium. Among the points of criticism here were that investment was defined very broadly, no account was taken of write-downs and asset sales, the requirement had to be met only at the planning stage but not when implementing the budget, burdens in special funds were not taken into account, and the exception was not defined in detail. On balance, these rules did not halt the depletion of government assets. The general government debt ratio rose to well over 60% without being accompanied by a matching increase in assets. See Deutsche Bundesbank (2005).
26 The debt brake under German Basic Law *(Grundgesetz)* will not apply fully to the state governments until 2020. Local governments can continue to finance investment through borrowing, but will have to furnish proof of their financial capacity.

interest expenditure or positive labour market developments was also used to reduce deficits.

… and not the cause of inadequate infrastructure

At the same time, Germany's infrastructure is still rated as above average in comparative international surveys.[27] Although it has shortcomings in various places, this can hardly be blamed on the new debt brake. Not least, there has been plenty of budgetary leeway even within these limits for some time now. Although other priorities have largely been set for using such scope, such as appreciably higher social benefits, investment budgets have nonetheless been topped up as well. The fact that infrastructural weaknesses are being remedied fairly slowly is probably also due to planning and capacity constraints, complex legal requirements, and lengthy approval procedures.

Complying with the debt brake and ensuring good infrastructure

All in all, introducing the debt brake was an important step for Germany. It again places sound public finances on a more reliable footing. The debt ratio will probably not reach the limit of 60% this year. However, the significant increase in demographic strains on the horizon means there are still major fiscal challenges ahead. This is one of the reasons why it is still advisable to apply the rules and, at the same time, ensure a very good public infrastructure within this framework.

Keeping an eye on the downsides of a golden rule in the European reform debate

The problems associated with a golden rule have meant that the European fiscal rules have largely shied away from introducing it, too. When the monetary union was established, placing a limit on government debt was seen as a priority. As part of the reform debate there are now occasional calls for investment to be considered more specifically in the form of a golden rule.

Requirements to limit risks of a potential golden rule and examples of design options

Important guidelines for potential special rules for investment

There are substantial concerns about a golden rule. If, however, the outcome of the current European debate is that the potential benefits outweigh such concerns, the important thing would be to narrow down the risks to a minimum. This would mean bearing in mind four principles.

Rapid reduction of high debt ratios

First, it should be ensured that high debt ratios do not decline more slowly if the rules are complied with. In other words, the budgetary objective should not be less ambitious than the current MTO. An upper limit should therefore also be agreed for the additional deficits and debt resulting from investment (a "capped" golden rule). This cap would also limit the risks arising from undesirable interpretations and over-investment.[28]

Only investment according to the national accounts to be included

Second, the investment to be recognised would have to be clearly and narrowly defined. One possibility would be government investment according to the national accounts. The national accounts provide an internationally harmonised definition of investment based on the build-up of a government capital stock. This could at least limit the scope for defining the concept of investment.

Additional debt only for positive net investment

Third, countries should be able to run up additional debt only to the same extent that they accumulate additional assets. When calculating the deficit limit, the write-downs according to the national accounts would have to be deducted from gross investment – in other words, only net investment would be separated out.

Taking a symmetrical approach in the event of negative net investment

Fourth, a symmetrical approach should be taken. If higher deficits were allowed in the case of positive net investment, then in the case of negative net investment – i.e. the consumption of government capital stocks – more ambitious budgetary objectives would have to be set.

In order to fulfil these requirements, a potential golden rule could be based on the existing

27 See Jaramillo et al. (2018); World Economic Forum (2018).
28 One of the things to be examined is whether only self-financed net investment is counted towards this limit. This would prevent, say, investment projects co-financed by the EU permitting a higher level of national debt.

Taking current MTO as starting point and continuing …

limits for the MTO. The existing rules allow a structural deficit of up to 0.5% of GDP provided that the debt ratio is not "significantly below 60%".[29] What counts as "significant" has not yet been quantified. Nonetheless, a debt ratio of below 50% could, as a rule, be considered to be an appropriate, quite sound basis for moderately easing the MTO.

… to ensure budgetary objective is …

Therefore, for debt ratios above 50% (i.e. not significantly below 60%), the structural deficit could be as high as net investment in the national accounts – but no greater than 0.5% of GDP. The MTO ceiling would thus continue to apply, but only if net investment amounted to at least 0.5% of GDP. If net investment were between 0% and 0.5% of GDP, deficits of the same amounts could be permitted. If net investment were negative, the government would need to run surpluses.

… differentiated by level of debt ratio

For debt ratios significantly below 60%, under the current rules, a structural deficit ratio that is higher by 0.5 percentage point can be set as the MTO, thus reaching up to 1%. In line with the above-described approach, for debt ratios below 50% deficits of at most 1% of GDP would be permissible only if net investment amounts to at least 0.5% of GDP. Given relatively sound positions such as these, consideration might, under certain circumstances, be given to adding the amount of net investment to the 1% limit – again up to a maximum of 0.5% of GDP. In other words, a structural deficit ratio of up to 1.5% would be allowed as long as net investment is at least 0.5% of GDP. If net investment is lower than that, more ambitious fiscal targets would have to be met. The debt ratio would potentially drop less significantly below 50%. However, very low debt ratios thanks to persistently balanced budgets would still be possible, because the MTO is not a target figure but an upper limit.

Investment protection on the adjustment path towards MTO, too

Investment could also be factored into the adjustment path towards the MTO. For example, provision could be made for falling investment expenditure being regarded as a contribution to consolidation only if net investment still comes to at least 0.5% of GDP. If net investment is lower than this, consolidation would have to be accomplished entirely through other expenditure categories or through revenue.[30]

Target/actual comparison

If investment expenditure is taken into account by the rules, fiscal surveillance would also have to track the actual level of investment. Investment expenditure being lower ex post (without lower deficits) would constitute a breach.

High debt ratios would continue to drop swiftly

This sample design of a strict capped golden rule would ensure that very high and high debt ratios decline swiftly given adherence to the rules. Due account would be taken of the risk that high debt ratios pose to monetary union. Only if debt ratios were significantly below the 60% threshold could thought be given to a somewhat greater easing of the MTO based on positive net investment.

Counteracting incentives to reduce investment

At the same time, this would counteract incentives to make excessive cuts to investment in order to comply with the European fiscal rules. The deficit targets would become more ambitious, the further net investment falls below 0.5% of GDP. This would mean that countries would be unable to comply with the fiscal rules by reducing investment expenditure to below 0.5% of GDP. Even where there is a need for structural adjustment, government investment would, at most, face limited consolidation pressure. This pressure would then arise in other areas. If the amount of net investment that can be counted were capped at 0.5% of GDP, any misguided incentives would be limited, thus mitigating the risks of inefficient over-investment or improper structures. This would not make higher government net investment impossible – it would just not be permissible for it to be financed by additional borrowing.

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29 See Treaty (2012), Article 3(1) letter (d).
30 If net investment was previously lower than 0.5% of GDP, investment expenditure could in fact rise to this level without increasing consolidation pressure in other categories. Overall, this would slow down debt reduction, but only by a little. Alternatively, instead of net investment of 0.5% of GDP, a figure of 0% could also be set.

Conclusion

There is a need for reform

The way in which the European fiscal rules have evolved is unsatisfactory, and the way in which they are being applied has become somewhat incomprehensible. Even during the favourable times of the past few years, very high debt ratios, in particular, barely declined in many cases. Fiscal surveillance evidently failed to induce further steps towards consolidation, and even instances of structural loosening went unpunished. There is a need for reform. The medium-term objective of the structurally (close to) balanced budget should be more binding on fiscal policymakers. This would ensure that high debt ratios fall swiftly. Numerous exceptions and discretionary scope should therefore be dispensed with.

Implement rules strictly

Limits must be implemented strictly. National parliaments retain responsibility for setting fiscal policy, but the pressure to adopt a sound stance could be increased. Progress in this direction could be expected if fiscal surveillance were to be transferred to a clearly focused independent institution. If an expenditure rule were to be introduced, the structural fiscal balance should remain the key reference point and guidepost. It could be converted into an expenditure ceiling which would have to be complied with in the budget planning and execution phases. The expenditure ceiling would be set only for the year ahead, not for multiple years. For each subsequent fiscal year, it would be newly derived from the current, rule-compliant structural balance or the required improvement in the structural balance.

Flexibility thanks to rainy day funds

National rainy day funds could create flexibility for fiscal policymakers within the framework of the rules, even if quantitative objectives were more stringent. For this to work, such funds would have to be better integrated into the fiscal rules. The funds would be stocked in advance from overachieving the medium-term objective (MTO) and should not create additional scope for borrowing. It would be advisable to stipulate solely rule-based utilisation of the funds, as a way of cushioning the impact of unexpected budget burdens, in particular. This would not require complex European mechanisms.

Reforms with debt reduction as their prime objective

Swiftly reducing high debt ratios should be a key objective of the fiscal rules. This should also be at the heart of deliberations on any reforms. This also holds true if the rules were geared, say, to greater protection for government investment. Such golden rules have considerable inherent problems and risks, and have often proved unsuccessful in the past. If the European rulebook moves in this direction nonetheless, it has to be ensured that the rules do not make compromises on the objective of rapidly declining high debt ratios. They should refer to narrowly defined net investment. In the event of capital depletion (i.e. negative net investment), a more ambitious fiscal position than at present would be called for. For debt ratios significantly below 60%, positive net investment could permit limited additional deficits.

Autonomous Member States – autonomous financing

Each Member State in the monetary union is responsible for its own fiscal policy and hence must also answer for its repercussions. Quite apart from the specific fiscal rules, each Member State decides whether or not to comply with the joint agreements and uphold them. The European level cannot intervene in fiscal policy to ensure that limits are complied with or debts serviced. This means that the rejection of joint liability along with individually liable financing on the capital market have to remain key elements of the fiscal framework in monetary union. Thus, it remains necessary for each Member State to make sure that no doubts arise on the financial markets as to the servicing of government debt. Potentially increasing risk premia still constitute a material incentive to run a sound fiscal policy. Targeted fiscal rules that are perceived to be binding can play a crucial role in creating and maintaining trust. But to do so, they have to be implemented in an appropriate manner, and compliance must be monitored transparently and sanctioned if and when required.

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The informative value of national fiscal indicators in respect of debt at the European level

Fiscal policy has been playing a significant stabilising role during the coronavirus crisis, and measures funded nationally are at the forefront of these efforts. That said, extensive fiscal packages have been initiated at the European level, too. More than €1 trillion in borrowing – i.e. above 7% of the European Union's gross domestic product (EU GDP) – has been lined up for grants and concessional loans. This is fundamentally different than before. First, this move is intended to usher in a significant increase in borrowing. Second, the funds raised will no longer be used only to supply assistance loans but also for issuing grants to Member States on a considerable scale. The upshot of this is that the European level will have notable deficits for the first time, and debt servicing will weigh on future EU budgets.

This article illuminates the impact of this European debt, and these European deficits, on the informative value of national fiscal indicators. Analyses are usually based on national data and examine matters such as the sustainability of public finances or the effect of fiscal impulses on economic activity. Up until now, the EU budget has largely featured in these analyses as a direct component of national fiscal indicators, given that it is mostly funded by contributions made in the same year by Member States. This meant it could be disregarded by analysts. The situation is now set to change. Looking ahead, national deficits and debt will be lower initially if a Member State's expenditure is funded not by national borrowing but by debt-financed EU grants. While this improves the Member State's national fiscal indicators, its financial position will not be any better overall. This is because European debt will need to be serviced by taxpayers in the Member States at some point in the future on top of the national debt burden. Instead of interest and principal payments on national debt, there will be larger contributions to the EU budget.

Given this backdrop, it is crucially important, from the perspective of economic and fiscal policy analysis, for government revenue, expenditure, deficits and debt to be computed using statistical methods and reported in a transparent manner not just nationally but at the European level, too. Disclosures should follow the definitions used in the national accounts and be made available in a timely manner, just as they are for the Member States. That particularly goes for the Maastricht deficit and the Maastricht debt level. This is not currently the case. The final decision adopting the programmes needs to enshrine this form of statistical reporting on developments at the European level.

These disclosures could be used to provide a more comprehensive picture of the fiscal burdens weighing on Member States, amongst other things. There would be less risk of losing sight of European debt and the fiscal strain it involves. Budgetary rules should likewise take the European fiscal burdens into account. Rules that apply only to national indicators will be hollowed out if deficits and debt are transferred on a significant scale to the European level. It would also make sense for the national fiscal indicators designed to measure the effects of a fiscal impulse on economic activity to give consideration to payment flows with the EU.

European government sector borrowing enters new dimensions

European assistance mechanisms in the coronavirus crisis

Fiscal policy has been playing a significant stabilising role during the coronavirus crisis, with individual Member States bearing the brunt of this challenge. That said, extensive packages have also been rolled out at the European level[1] in support of Member States.[2] Measures include:[3]

- Up to €240 billion in debt raised by the European Stability Mechanism (ESM) for concessional loans to euro area countries;
- EU debt of up to €100 billion for concessional SURE loans[4] to EU countries; and
- EU debt of up to €750 billion (at 2018 prices)[5] for Next Generation EU (NGEU) assistance in the form of grants and concessional loans to EU countries.

New assistance heralds substantial changes …

The European level had already raised debt before the advent of the coronavirus crisis, though the volume at that time was considerably smaller (EU: just over €50 billion; ESM: just under €120 billion). The newly adopted assistance programmes are set to be significantly larger in scope. On top of this, the NGEU programme is designed not only to provide loans to Member States but to issue non-repayable grants as well. In the past, EU debt was normally backed by claims on Member States, the idea being that it would be serviced out of the borrowers' debt service payments. In effect, the European government level reported no deficits (within the meaning of the national accounts) because the (net) financial assets remained unchanged. Under the new grant programmes, however, there are no credit claims to offset the European debt, which means the European government level will run deficits as defined in the national accounts. In subsequent years, the debt raised to fund these programmes will then have to be serviced out of the EU budget using Member State contributions.[6] The EU budget will need to cover any interest charges that accrue plus the principal payments over the period from 2028 to 2058. Contribution-financed surpluses (as defined in the national accounts) would need to be generated in the EU budget in the amount needed to cover the principal payments.

… that influence the informative value of national fiscal indicators

Under the existing arrangement, any deficits and debt incurred at the European level are not reflected in the deficits and debt levels reported by Member States. This makes future national fiscal indicators less informative. Up to now, EU expenditure has largely been reflected directly in the aggregated national indicators, given that it was normally funded by Member States in the same year by their contributions to the EU budget. This meant that Member States' deficits and debt levels were correspondingly higher. The new arrangement will see a not-

1 For the purposes of this article, "European level" means government activity at the supranational European level. The government sector at the European level comprises EU institutions, such as the EU budget, as well as intergovernmental agreements between European states, such as the ESM.
2 For the decisions from April, see Deutsche Bundesbank (2020a); for those from July, see Deutsche Bundesbank (2020b) and the box on p. 39.
3 Member States are contributing furthermore, in the form of guarantees, to the pan-European guarantee fund created by the European Investment Bank (EIB) with a view to mobilising up to €200 billion as a source of financial support, above all for small and medium-sized enterprises. The EIB does not form part of the European government sector. Routine checks are generally made to establish whether activities performed by non-government units at the request of government should be assigned for statistical purposes to the government budget (rerouting). Some activities performed by KfW Group on behalf of the Federal Government fall into this category, for example. If the pan-European guarantee fund were to provide actual funding in addition to guarantees, this would probably have to be recorded statistically in the budgets of participating Member States.
4 SURE stands for "Support mitigating Unemployment Risks in Emergency".
5 Stating figures at 2018 prices means that the authorised volume of loans and grants increases annually at a fixed rate of 2%. This arrangement means that the NGEU programme will have a volume of €795 billion (€750 billion at 2018 prices) in its scheduled launch year of 2021. Since not all the resources will be allocated in 2021, the total amount, priced accordingly, will depend on how it is distributed over time; the volume here refers to payments (rather than commitments incurred).
6 The plan is for Member States to fund these additional contributions in part by levying a new tax harmonised across the EU.

Borrowing options available at the European level for funding COVID-19 response measures

To help alleviate the impact of the COVID-19 crisis, it was agreed in April 2020 to simplify access to the credit facilities offered by the European Stability Mechanism (ESM). This step means that euro area countries can now draw on credit facilities even if they are not subject to a macroeconomic adjustment programme. Funding for this European debt is jointly guaranteed via the ESM, which is why the ESM's assistance loans (up to 2% of euro area gross domestic product (GDP) in total, which roughly equates to €240 billion) offer particularly favourable interest rates. The Member States have not yet applied to use any of the ESM's credit lines, however.

In addition a new instrument known as SURE ("Support mitigating Unemployment Risks in Emergency") was created. This authorises the European Commission to raise up to €100 billion in debt on the EU's behalf. The idea is to provide EU Member States with concessional loans so that unemployment risks can be mitigated – for example, by providing short-time work benefits. Eighteen countries intend to tap into these loans, and around €90 billion has already been earmarked. Borrowing for the SURE instrument is underwritten by guarantees issued by Member States alongside what are known as budgetary margins. These margins in future EU budgets come about because the maximum amount of Member States' contributions to the EU budget that can be drawn down (the own-resources ceiling) is higher than the annual expenditure in the EU budget.

July 2020 saw the European Council agree on the Next Generation EU (NGEU) assistance programme which, like SURE, is funded by EU borrowing. Repayment is guaranteed by increased margins in future EU budgets. NGEU's expected volume is €750 billion (at 2018 prices). Its centrepiece is the Resilience and Recovery Facility (RRF), which will see Member States receiving (non-repayable) grants totalling just over €310 billion. Further NGEU grants (of just under €80 billion) are to be provided through programmes included in the forthcoming medium-term financial framework's EU budget. Member States furthermore stand to receive a total of €360 billion in concessional loans. Funding conditions for the NGEU debt will probably be very favourable because the budgetary margin securing it is scheduled to rise sharply. Specifically, the own-resources ceiling is to be increased by 0.6% of gross national income (GNI) till 2058 (to 2% of GNI). If scheduled payments are not made (for example, if a country does not service its assistance loan), the remaining countries will generally be approached to cover payment on a pro rata basis.

NGEU has not yet been adopted, so a final decision on how the resources will be allocated across Member States is still pending. The European Commission has tabled a grants allocation key per Member State, based on population size, per capita GDP and pre-crisis unemployment. The decline in GDP brought about by the coronavirus in 2020 and 2021 will only be a factor for a small part of the grants. Loans are to be capped at 6.8% of a country's GDP. All NGEU resources need to be committed by the end of 2023 but can also be disbursed at a later date. Outflows will ultimately depend on how the national plans are implemented.

able portion of deficits and debt being shifted to the European level. National deficits and debt will be depressed (c.p.) when the European level borrows funds to disburse to Member States in the form of grants. The upshot of this is that the national fiscal indicators will appear more favourable initially, though European debt will still need to be serviced out of Member States' tax revenue, in addition to their national debt. In later years, Member States will face the burden of higher contributions to the EU budget to service the debt. Analyses of economic and fiscal policy will need to take account of these shifts between the national and European levels, which is why developments at the European level merit attention alongside the national fiscal data.

Make comprehensive reporting at the European level mandatory to create transparency

Established statistical reporting system …

Economic and fiscal policy analysis can only deliver meaningful insights if the underlying national and European statistics alike are compiled in a complete, reliable and transparent manner. The European System of Accounts (ESA) is a harmonised reporting system, with Member States providing comprehensive sets of quarterly data in a timely manner. The ESA catalogues the various revenue and expenditure items for the government sector, with the balance being shown as net lending (+) or borrowing (-) as defined in the national accounts. The Maastricht debt level of Member States is likewise calculated and disclosed according to a harmonised set of standards.

… would need to be supplemented by data for the European level

Comparable data have not yet been made available for the European level, but it would be important to do so, given the plans for the European level to incur deficits and debt on a substantial scale. Like the Member States, the European level needs to provide a complete set of national accounts data in a timely manner following the same classification criteria. Similarly, the Maastricht debt level and fiscal balance should be disclosed in Eurostat's press releases together with the national indicators. Any methodological issues should be ironed out by the same bodies that already ensure that national data are harmonised and quality-assured. In addition to the EU budget and the NGEU and SURE instruments, any other government activity at the European level would also need to be reported, showing the financial links to Member States. In the integrated national accounts system, the corresponding government revenue and expenditure items at the European level should match those reported at the Member State level. Another important point is to include the European level in the data on EU and euro area aggregates. The final decision adopting the NGEU programme should include a clause requiring the relevant statistical information to be made available in the future.

Supplement national fiscal indicators by adding information on the European government sector

Allocation creates transparency

There now follows an example of how national fiscal indicators could be supplemented by disclosures on the European government sector. Since it is based on what currently appear to be plausible assumptions for the European level, the expected magnitude can be visualised for particularly relevant indicators.

Allocate European debt to Member States

Report and allocate European debt as a supplementary disclosure item

Debt at the European level is ultimately the responsibility of the Member States. For instance, they underwrite the debt, commit to servicing that debt through contributions to the EU budget, or stand ready to inject additional capital into the ESM. For these reasons, European debt should be taken into account for analytical purposes; depending on the issue being

analysed, it may also make sense to allocate them proportionally to the individual Member States.[7]

Allocate existing and …

This applies to the EU debt already accumulated by end-2019,[8] which came to just over €50 billion and is linked to balance of payments assistance to non-euro area countries, assistance from the European Financial Stabilisation Mechanism (EFSM) established during the financial and debt crisis, and financial aid to third countries. This is topped off by debt of just over €110 billion from the ESM (end-2019) which was used to grant assistance loans to euro area countries.[9]

… new European debt …

Another point is that, according to current budget plans, European debt is set to rise sharply this year and in the years thereafter.

– By the end of October, the European Commission had already borrowed €17 billion for the SURE programme. This figure could come to €30 billion by the end of the year, and the total volume of €100 billion could be disbursed by the end of 2021.

– With regard to NGEU assistance loans, the 18 Member States that have applied for SURE assistance loans to date could conceivably also take out NGEU loans to the largest extent permitted (6.8% of national GDP). Most of the maximum volume of €360 billion (at 2018 prices) would thus be taken up. It could be distributed according to a schedule similar to that for the NGEU grants.

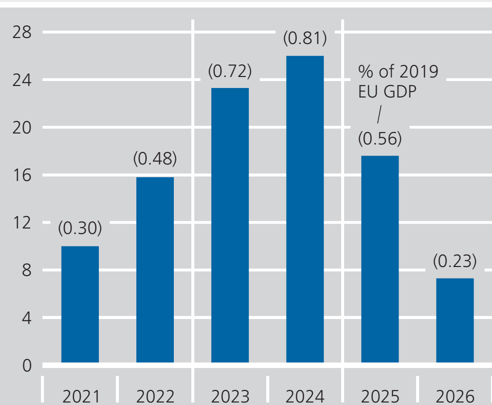
– The payment of the NGEU grants and the associated debt (around €390 billion at 2018 prices) will depend on how the national plans are implemented. The European Commission had assumed that outflows would rise fairly continuously until 2024 before falling again rapidly (see the chart above).[10]

– With regard to the timeline of the NGEU programme the planned annual price adjustment of 2% should be taken into account (for more information, see footnote 5). By the end of 2026, this would culminate in a total volume of debt of just over €820 billion at current prices.

– As ESM credit lines have not yet been used to finance COVID-19 response measures, the analysis does not include any additional European debt stemming from this.

NGEU* grant payments: possible time profile

As a percentage of total resources



* Next Generation EU.
Deutsche Bundesbank

7 The Maastricht debt level is a gross figure and also reports debt which is matched by financial assets. Financial assets can be included in more in-depth analyses. For European debt, these would be European financial assets (such as claims on Member States).
8 The debts from the European Financial Stability Facility (EFSF) are attributed to the Member States. For the purposes of the national accounts, it is assumed that EFSF loans are not granted by the EFSF, but by the Member States. Equally, it is assumed that Member States will refinance themselves via loans from the EFSF. In this way, the debts from the EFSF are already captured in the Member States' national debt.
9 The recipient countries' debts vis-à-vis the ESM amount to €90 billion.
10 The European Commission outlined the potential timeline for the disbursement of the Recovery and Resilience Facility (RRF) grants in its proposal of May 2020. By contrast, this article assumes that 10% (rather than just under 6%) of the grants will be up and running in 2021, and that all grants will be disbursed to the Member States by the end of 2026 (rather than 2028), which is what the European Council had agreed. See European Commission (2020a), p. 40, and Council of the European Union (2020), p. 9 and p. 11. No information is available about the envisaged timeline for the non-RRF grants. For the purposes of the calculations performed in this article, they are distributed according to the same schedule as the RRF grants. The country shares expected by the European Commission sometimes differ from the share for RRF grants. See European Commission (2020b, 2020c, 2020d).

… to Member States according to GNI share

To allocate this European debt to the Member States for analytical purposes, a distribution key first needs to be established. In terms of EU debt, a country's share of financing in the EU budgets is a key factor. It is likely to remain broadly the same as a country's share of EU gross national income (GNI).[11] According to this, around one-quarter of European debt would be allocated to Germany. In the scenario described above, by 2026, this would amount to more than €280 billion, or around 8% of GDP of the year 2019 (including the ESM).[12]

Allocate European deficits to Member States

European deficits and surpluses should likewise be allocated to the Member States for greater transparency

Deficits at the European level create a definite – rather than just a potential – future burden for Member States. It is therefore particularly important to take these into account when interpreting national indicators. This can be demonstrated using an illustrative example. The EU could borrow 10% of EU GDP and use these funds to disburse equally tranched grants to Member States over a period of four years. This would reduce their national deficits in each of these four years by around 2½% of their GDP. A glance at the national indicators alone would overstate the fiscal situation for this period. Although the deficits would have been shifted to a different level, this would not ease the burden on taxpayers. Shifts such as this could also hollow out those fiscal rules that target the national indicators. This would be the case, for example, for the 3% ceiling on national budget deficits under the Stability and Growth Pact.[13]

Markedly higher deficit ratios at times, owing to allocating burdens from NGEU grants

Specifically, because of the NGEU grants (according to the assumptions outlined above), deficits of around €430 billion or 3% of EU GDP of the year 2019 are planned at the European level.[14] The deficit would be highest in 2024, at over €110 billion, or 0.8% of GDP of the year 2019. In turn, each Member State would then be allocated around 0.8% of the relevant GDP figure, according to its share of funding in the EU budget.[15] Around €30 billion would be allocated to Germany in 2024, for example.

Measure fiscal stance more accurately

The fiscal stance …

Besides the deficit and the debt level, the fiscal stance is an indicator that is commonly used in analyses.[16] It is designed to show whether fiscal policy in a given year has been eased or tightened compared to the year before. It is often measured as the annual change in the cyclically adjusted primary balance,[17] which is the fiscal balance (deficit or surplus) excluding interest expenditure and cyclical influences.

11 Deviations from this are the result of agreed contribution rebates. See Deutsche Bundesbank (2020c). For the sake of simplicity, these will be disregarded below. The financing shares could well change in the future, for instance in connection with the introduction of a new tax harmonised across the EU. With regard to ESM debt, the current ESM capital key of the euro area Member States would apply. This is based primarily on a country's share of euro area GDP. Population size and special clauses are also taken into account. See ESM (2020).
12 As usual, the allocated NGEU debt is expressed over GDP, while the distribution key is based on GNI. On balance, however, the ratios are largely identical for most countries. As is the case for the Maastricht debt level, the calculations here refer to gross debt. However, it should be borne in mind that some countries are in receipt of assistance loans that are included in the national debt level and that capital has already been injected into the ESM. There are several ways to take this into account when fine-tuning the calculations.
13 In the repayment phase of EU debt (surplus at the European level), the budgetary rules would inversely oblige Member States to commit to a more frugal fiscal policy than would be the case when including the EU level.
14 There is no (marked) deficit in the ESM.
15 The actual ratio depends on the extent to which GDP differs from that of the base year 2019. Moreover, the results of some countries may differ (slightly) from the EU-wide figure. This is the case for Ireland, for instance. In the example figures selected, the deficit ratio rises by 0.2 percentage point less because Irish GDP is markedly higher than GNI.
16 See, for example, European Commission (2020e), p. 58, and European Fiscal Board (2020).
17 In other analyses, the fiscal stance is also measured as a change in the structural primary balance. This is calculated by excluding temporary policy measures as well as cyclical components and interest expenditure. In addition, both the change in the structural and in the cyclically adjusted primary balance ratio are often used as an indicator of fiscal consolidation or easing. In the European rules, this is measured by the change in the structural balance.

… is often used to assess the impulse from fiscal policy

The fiscal stance is also interpreted as an impulse which emanates from fiscal policy to macroeconomic developments. The term "expansionary fiscal policy" is used, for example, when the cyclically adjusted primary balance falls compared to the previous year. This happens, for instance, if cyclically adjusted primary expenditure rises faster than cyclically adjusted revenue. It is then assumed that fiscal policy stimulates economic activity. Conversely, a rise in the cyclically adjusted primary balance tends to have a dampening impact on the economy. It may be the result of tax increases or spending cuts, for example.

Special factors distort the indicator

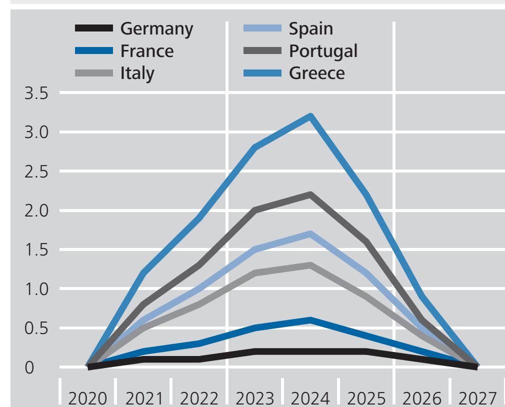
The indicator is calculated on the basis of the national accounts balances for the relevant years. In the case of NGEU grants, however, the resulting picture is distorted in terms of the cyclical impulse. If, for instance, a Member State receives large NGEU grants for the first time in 2021, this will increase the national balance compared with the previous year (revenue and expenditure being otherwise unchanged). This means that the cyclically adjusted primary balance in 2021 will also be higher than in 2020, and the fiscal stance for 2021 is measured as being restrictive. However, the grants received from abroad (the EU) do not have a dampening effect on national economic activity. This is because no domestic resources are withdrawn, as would be the case, for instance, if higher government revenue were the result of an income tax hike. If the NGEU grants decrease over time, national deficits will increase in themselves without triggering an expansionary stimulus.

NGEU grants should be disregarded, …

If the fiscal stance is to indicate how fiscal policy stimulates the domestic economy, the logical next step would be to exclude the NGEU grants received. For some countries, the difference from the unadjusted figure may be considerable in some years. For example, the fiscal stance for Greece in 2021 – based on the above-mentioned assumptions (see the chart on p. 41) – is looser by around 1% of GDP after NGEU grants have been deducted. The corresponding figure for Germany, which is expected to receive relatively small grants, would amount to just 0.1% of GDP. For the euro area as a whole (like in the EU), the fiscal stance would therefore be 0.3 percentage point looser than in the absence of adjustment for the aggregated national balances.

Expected NGEU* grants to Member States

As a percentage of each country's national GDP in 2019



* Next Generation EU.
Deutsche Bundesbank

… as should countries' financial relations with the EU budget overall …

Obtaining the best possible indicator of the fiscal stance as an economic stimulus is not achieved solely by adjusting for NGEU grants. Member States' other financial relationships with the European level can also skew the fiscal stance indicator. This is the case if a Member State's net position with regard to the EU budget fluctuates strongly from year to year. In the past, this has been fairly significant for some Member States. In view of this, adjustments would have to be made not only for NGEU grants received, but also for all revenue and expenditure vis-à-vis the EU budget.

… and with the rest of the world as a whole

An even more extensive and accurate approach would be to adjust for all the revenue and expenditure flows of the country in question with the rest of the world. However, fluctuations beyond those in connection with the EU budget are often likely to be rather small. To reliably gauge the impact of public finances on economic activity, numerous additional factors would also have to be taken into account;

“Fiscal stance” as an indicator of the fiscal impulse on economic developments

Definition and usage

The impact of fiscal policy on macroeconomic developments is a topic of interest for economic policy. An indicator often used for the fiscal impulse is the change in the cyclically adjusted primary balance of general government (as defined in the national accounts). Automatic stabilisers (cyclically induced balances) and government interest expenditure are factored out of the general government fiscal balance in the cyclically adjusted primary balance.[1] The change in the cyclically adjusted primary balance is also known as the “fiscal stance”. If the relevant government revenue falls, or if expenditure rises, the balance decreases, all else being equal. According to this definition, the fiscal stance would then be described as “expansionary” or “loose”. The opposite developments would be described as “restrictive” or “tight”. This indicator is frequently used for fiscal policy analysis, which also forms the basis for policy recommendations.

From an analytical perspective, the fiscal stance is an indicator that provides an initial approximation, relative to the previous year, of the impulse of government finances on overall economic developments. However, the concrete macroeconomic repercussions of this impulse can only be estimated with a considerable degree of uncertainty. Amongst other things, they depend on which government revenue and expenditure categories change as well as on the circumstances. Furthermore, the cyclical development of the government budget deducted from the indicator can be evaluated differently depending on the estimation method used. In times of heightened uncertainty in particular – such as the ongoing coronavirus crisis – this can result in significant differences with regard to the fiscal stance indicated for a given country.

Impact on gross domestic product dependent on a variety of factors:

Underlying categories of revenue and expenditure

Identical changes in different categories of general government revenue and expenditure can have different effects on macroeconomic developments. Most analyses, for example, come to the conclusion that increases in government expenditure generally provide greater stimulus to the economy than tax cuts of the equivalent volume.[2] Fiscal policy can therefore have an impact on gross domestic product (GDP) even if the fiscal stance indicator reports neutrality.

In this context, the impact of individual categories is often subject to debate. The estimation is dependent on both the exact specifications of the analyses and the prevailing circumstances. For example, it is difficult to gauge how assistance for banks or for enterprises that were closed for a time due to the pandemic stabilises economic activity over the short term.

By contrast, payment flows with other countries mostly have a minimal impact on domestic economic developments. A strong

1 To a large extent, the fiscal stance is a reflection of measures actively taken by general government (such as tax increases or expansions in investment). For this reason, it is often seen as a yardstick for the active loosening or tightening of fiscal policy. However, other influencing factors can also shape the fiscal stance (such as rising pension expenditure due to a growing number of pensioners). The fiscal stance also captures temporary factors that only have an impact on the balances for a limited period of time. These may include fiscal policy measures (e.g. a one-off child bonus) as well as factors outside the control of fiscal policy, such as tax refunds as a result of court rulings. Temporary influencing factors have neither a positive nor negative impact on the fiscal outlook over the long term. Instead, their impact on macroeconomic developments depends on the specific circumstances in each case.
2 See Gechert (2015).

case can be made, then, for adjusting the fiscal stance indicator for these payment flows if they fluctuate significantly over time (see also p. 46).

Timing inconsistencies

Timing inconsistencies also play a key role in the impact of fiscal policy on GDP. For instance, a fiscal policy impulse occurring today often influences macroeconomic developments only after a certain amount of time. A reduction in income tax could, for example, be reflected in a lagged response of private consumption – especially if consumers are initially uncertain about their individual relief. On the other hand, the impulse could also take effect before the payment flows, for example if enterprises are provided with more generous depreciation allowances.

Cyclical conditions

Depending on the underlying cyclical conditions, a fiscal policy impulse can have different effects. For example, it is generally likely to have a stronger impact on real GDP if production capacity is not fully utilised. In the event of overutilisation, by contrast, a fiscal policy impulse would instead lead more to price inflation than to greater real growth. The monetary policy response is also important: in general, an opposing reaction is often likely (given a non-binding zero lower bound on interest rates), as an expansionary fiscal policy impulse causes inflation to rise, all else being equal. If this dampening effect does not materialise, the fiscal policy impulse has a stronger impact.

Other underlying economic conditions

In addition, other, country-specific factors can have an influence on the impact of a fiscal policy impulse.[3] For example, an expansionary impulse will probably be less effective if government solvency is subject to doubt. Under such circumstances, private investment, amongst other things, is hindered by potentially rising risk premia that spill over into the private sector as well as by heightened uncertainty overall.[4] An economy with a high import ratio would also be likely to show a weaker response to a fiscal policy impulse than a more closed economy. Furthermore, propensity to save among the general public influences the effects of the impulse. For example, for populations with high saving ratios, additional disposable income resulting from an expansionary impulse only leads to a limited rise in consumption.

Formation of expectations

Last but not least, expectations play a role. Amongst other things, these are influenced by communication. For example, if the announcement that a reduction in value added tax will be limited in time is considered credible, households will expect prices to rise again at a later point in time and bring their consumption forward accordingly. However, if new government borrowing is interpreted primarily as an indication that the future tax burden will be heavier, an intended expansionary impact can fizzle out in the form of additional private saving.

Conclusion: Indicator should be interpreted with a high degree of caution

The "fiscal stance" indicator provides a broad impression of the impulses of fiscal policy on short-term economic developments. The informative value of the indicator can be improved by adjusting it for categories of revenue and expenditure that fluctuate more strongly and that clearly have only a limited influence on the economy. These can include general government payments to and from abroad. Beyond this, however, the impact of fiscal policy on macroeconomic developments still depends on a number of additional factors. The indicator should therefore be interpreted with caution.

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3 See Ilzetzki et al. (2013).
4 See Blanchard and Zettelmeyer (2018).

however, this would, for its part, increase computational complexity. In any case, the fiscal stance indicator should generally be interpreted with caution (see the box on pp. 44 f.).

Conclusion

Extensive European debt …

Fiscal policy has been playing a significant stabilising role during the coronavirus crisis. Besides national measures, European assistance mechanisms have been set up at the price of accumulating large-scale European debt and deficits. These are not usually envisaged, and are therefore also only intended to be temporary.

… should be taken into account in fiscal analyses

The new dimension which European debt and deficits have taken on means that they need to be taken into account in fiscal analyses. Existing national indicators (such as the Maastricht deficit or Maastricht debt) do not capture European debt and deficits and will therefore no longer be fit for purpose in the future. This presents a number of risks, one being that the resulting burdens might go unnoticed. That could increase the incentive to shift ever more debt from the national level to the European level, and propensity to borrow could increase.

Transparency and statistical reporting are vital

In terms of fiscal and economic policy analysis, it is important for government activities at the European level to be statistically recorded in a comprehensible manner using relevant national accounts data. This has not been the case so far and should form part of the final decisions. One priority should be timely disclosure of the Maastricht debt and fiscal balance at the European level. This would allow European deficits and debt to be allocated to the Member States for the purposes of economic and fiscal policy analysis. They should also be taken into account in the fiscal rules. Moreover, the fiscal stance indicators for the Member States and the EU aggregate as well as for the euro area as a whole could be compiled and presented in a more suitable manner. This would place associated policy recommendations on a sounder footing, for example.

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