Could a Debt Repayment Pact Lead Europe Out of the Crisis?

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- The strictly conditional solidarity imposed on the crisis countries has cast them into a vicious circle of high public debt, drastic austerity measures and sharp declines in growth. The heightened budgetary supervision has limited scope as a means of stabilising the Eurozone since it does not remedy external imbalances.

- In its latest annual report, Germany's Council of Economic Experts presented an innovative proposal to resolve the euro crisis in the form of a debt repayment pact. It differs from the one-sided approaches that have been predominant so far.

- At the core of the debt repayment pact is the temporary funding of that part of public debt that exceeds the 60 per cent limit laid down in the Stability and Growth Pact. A repayment fund is to be used to reduce member states' debts over a period of 20–25 years. The yields on these jointly guaranteed debts are likely to be significantly lower than the interest currently required by the market for crisis countries such as Italy and Spain.

- Bringing interest rates down will gain time for a sustainable consolidation path and growth-friendly reforms. However, the instruments of fiscal discipline proposed for that purpose are too rigid and stimulatory schemes are entirely lacking. Furthermore, the debt repayment pact can succeed only if the ECB is authorised to complement debt reduction with a monetary »mantle of growth«.

Content

1. The Vicious Circle of Public Debt, Austerity Policy and a Growth Slump[1]

For the European Union, 2011 was an inauspicious year. As the year progressed, it became progressively more difficult for the southern Eurozone member states in particular to finance their new borrowings, which had increased significantly in the wake of the financial crisis. On the markets for public debt this found expression in mounting yields (yield premiums) on government bonds. According to prevailing opinion, the measures taken by the member states and the EU so far are insufficient to effectively contain speculation against sovereign debt. Poor communication has done even more to exacerbate the crisis. After a debt haircut had been tabled by members of the German government in summer 2011 and in autumn of that year even the prospect of Greece's exit from the euro, speculation gathered momentum. Finally, even euro-heavyweights Italy and Spain had to pay significantly higher interest rates on newly incurred debt.

The drastic budget consolidation already implemented in the member states concerned – which in 2011 amounted to up to 6.9 per cent of economic output (deficit reduction in comparison to 2009: see Table 1) – was not rewarded by the financial markets with a lower interest burden.[2] Against the background of the worsening social situation in Greece and Spain, for example, the question of whether the way out of the euro crisis lies in a further intensification of the austerity measures becomes ever more urgent. The institutional innovations currently under discussion in the EU – such as automatic sanctions in the implementation of the Stability and Growth Pact and the introduction of national debt brakes – are clearly heading in this direction. It is questionable, however, whether this approach – which might in any case take years – is practicable, given the previous dynamics of the euro crisis. Finally, even the rating agencies have had to recognise that a one-sided austerity programme cannot end the plight of the crisis countries.

What the crisis countries need are a rapid fall in the interest rates on their government debt and stabilisation of economic prospects. The two are likely to be connected. Although government austerity efforts can at first lead to a reduction in planned new borrowing, as a rule they are accompanied by economic slowdown. So-called negative multiplier effects are unleashed by government austerity policies especially in periods of low economic activity and in many member states can cause a slump in growth that exceeds the cuts.[3] As a result, incomes and tax revenues fall so that the planned reduction of new borrowing cannot then be achieved. This can be illustrated among other things by the relative synchronisation

1. The author would like to thank the members of the FES working group for helpful comments and remarks on earlier versions of this text.

2. This had been urged in a joint appeal before the euro crisis summit in December 2011 by Sigmar Gabriel, Frank-Walter Steinmeier, Renate Künast, Cem Özdemir, Claudia Roth, Jürgen Trittin and Peter Bofinger: »Zwölf Punkte gegen Merkels Krisenstrategie«, http://www.sueddeutsche.de/politik/punkte-gegen-merkels-krisenstrategie-spd-und-gruene-attackieren-die-kanzlerin-1.1229829

3. For an overview of the fiscal spending multipliers of various EU member states see: Pusch, T. (2012): Fiscal Spending Multiplier Calculations based on Input-Output Tables – an Application to EU Member States. Intervention 1/2012 (forthcoming).

Table 1: Budget consolidation and economic growth, selected Eurozone member states

Crisis countries:	Budget deficit 2011 (% of GDP)	Budget consolidation from 2009 to 2011 (deficit rate reduction in %)	Economic growth from 2009 to 2011 (in %)
Ireland	10,3	–3,9	0,7
Greece	8,9	–6,9	–8,8
Spain	6,6	–4,5	0,7
Italy	3,8	–1,5	2,1
Portugal	5,8	–4,3	–0,5
By comparison:			
Germany	1,3	–1,9	6,7
France	5,9	–1,7	3,1

Source: AMECO (estimate, October 2011).

of strict budget consolidation and weak growth dynamics in the problem countries (of which Italy, which hitherto has experienced relatively low consolidation, is still in the best position: see Table 1). Budget consolidation in the EU should therefore be undertaken prudently and is unlikely to succeed unless countries do not all impose austerity measures at the same time and the external environment is favourable.[4]

In fact, many of the actors concerned are aware of this state of affairs. Even the rating agencies justified their recent downgrades of European states in terms of the deteriorating growth prospects, which are undoubtedly linked to budget consolidation. However, also part of European reality is the insistence of the donor countries offering financial support on far-reaching budget consolidation and demands for corresponding readjustments in the event of breached debt targets. The crisis countries are thus compelled to institute supplementary budgets in the course of the year and make further cuts. Due to the continual government austerity efforts, which are not likely to end for the foreseeable future, the economic prospects of the private sector are further destabilised, leading to renewed caution, declining momentum and thus revenue losses.

2. Current State of Budget Policy Supervision in the Eurozone

Since the beginning of the euro-crisis there has been fierce debate on how to overcome it. The European Financial Stability Facility (EFSF), a rescue fund, was set up with the IMF as a short-term measure to assist countries with budgetary difficulties. The IMF and the EFSF currently provide loans to Greece, Ireland and Portugal. The loans have been subject to strict conditions from the outset. The goal of reducing public debt is to be achieved in the medium term via budget cuts, raised taxes and growth-promoting reforms. In practice, this has proved difficult so far. Greece in particular is in a negative economic spiral, such that loan repayments are looking increasingly improbable.

In parallel with the short-term crisis aid in 2011 renewed efforts were put into European instruments to bring about the long-term stabilisation of the Eurozone. Particularly worth highlighting is the so-called »Sixpack« adopted in September 2011, comprising six regulations on limiting government debt and macroeconomic supervision. The Sixpack first of all envisages new rules on tightening up the Stability and Growth Pact. In future, it will be possible to halt deficit procedures that have already been instigated, including possible sanctions, only on the basis of a qualified majority of EU finance ministers (in the ECOFIN Council). Hitherto, a relatively large majority was required in order to impose sanctions. With the new procedure the imposition of sanctions in the ECOFIN Council will be much more likely. Furthermore, the deficit procedure can now only be introduced if the guideline of 60 per cent of government debt – measured in terms of GDP – is exceeded and no adequate consolidation efforts are undertaken to rectify the situation. Such efforts are deemed to be in place when government debt in excess of the 60 per cent criterion is reduced by one-twentieth each year. At the European crisis summits in December 2011 and January 2012 it was further agreed, as regards intensifying individual states' consolidation efforts, that the Eurozone member states and some other EU member states should adopt national debt brakes, to be safeguarded by an international treaty which is yet to be negotiated.

Besides the stricter Stability and Growth Pact the Sixpack also contains a regulation on monitoring macroeconomic imbalances. Such imbalances are to be determined by indicators of price competitiveness, such as unit labour costs and external imbalances. This procedure is very welcome since in the run-up to the financial crisis some of today's crisis countries were by no means running excessive budget deficits. However, marked external imbalances in, for example, Ireland and Spain before the crisis indicated high private debt which turned into a parlous budgetary situation when the real estate bubbles burst. In contrast, countries such as Germany and the Netherlands had large foreign trade surpluses, part of which took the form of problematic investments in the current crisis countries (and in the United States), thus fuelling the real estate bubbles. The link between external imbalances and the euro-crisis makes it clear that budget consolidation has only limited use as a means of bringing about sustainable stabilisation in the Eurozone.

4. See Karl Aiginger and Margit Schratzenstaller (2010): Budget Consolidation in a Difficult Environment – Ten Guidelines Plus a Preliminary Reality Check, WiFo Working Paper No. 381.

3. A Prudent Proposal: The Debt Repayment Pact

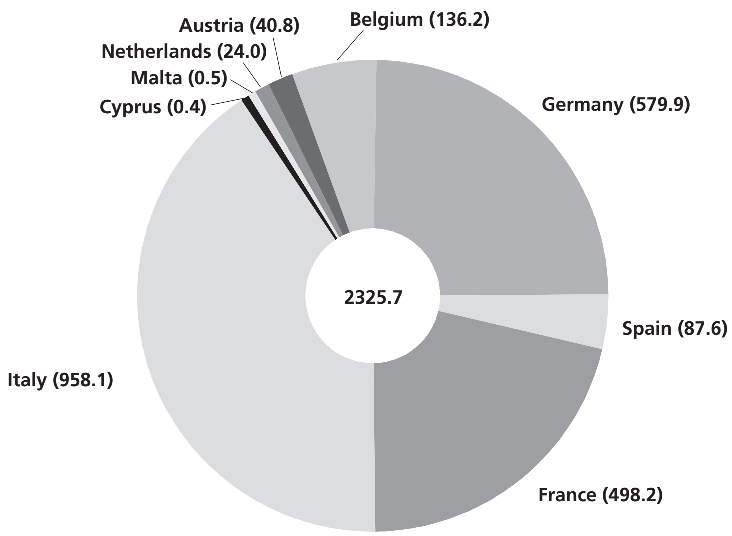
On important economic questions the German government is advised by a Council of Experts (often referred in the press as »the five wise men«). In its recent annual report – 2011/2012 – the Council of Experts proposed a debt repayment pact which could represent an interesting contribution to resolving the euro-crisis.[5] The pact would basically involve temporary joint financing of that part of government debt in EMU member states that exceeds 60 per cent of economic output. In particular for countries with a very high level of government debt, such as Italy, such a step could provide some relief since the interest on the jointly guaranteed debt, assuming the appropriate institutional design, is likely to be much lower than the yields currently demanded by the market. At the same time, the inclusion of Italy and Spain would take the wind out of the sails of market speculation since the inadequate volume of the EFSF and the ESM for financing these state budgets would no longer be an issue. Countries already in an adjustment programme (Greece, Ireland, Portugal) are not included in the proposal and will remain within the scope of the IMF, the EFSF and the ESM (succeeding the EFSF). The debt repayment pact can thus in the first instance be regarded as a proposal for containing the euro-crisis in the Eurozone's larger economies (Italy, Spain and possibly France).

5. See Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung [Council of Economic Experts] (2011): Verantwortung für Europa wahrnehmen, Jahresgutachten 2011/12.

The debt repayment pact envisages that the participating countries be allowed joint financing for a period of five years (roll-in phase). For this purpose, jointly guaranteed debts would be assumed on the financial markets and the funds would be passed on to the participating countries. The credit range thus made available would be predetermined by the extent to which the national debt diverges from the Stability and Growth Pact's 60-per cent criterion at the beginning of the joint borrowing. Italy, for example, could therefore convert around half of its current debt over the five-year period into jointly guaranteed debt securities (the rest would remain under national guarantee). As of the end of 2011, this corresponds to around half the possible borrowings via the debt repayment pact (see Figure 1). Other participating countries with a considerable financing sum in the fund would be Germany and France. In due course, these debts are to be repaid by the participants in accordance

Figure 1: Maximum financing volumes from the repayment fund (as of the end of 2011)

Debt repayment pact »repayment fund« in the euro-area (2011)[1)]
(billion euros)



1) Government debts that exceed the 60 per cent threshold. Greece, Ireland and Portugal are not included because they are in an adjustment programme.

with the level of the sum borrowed. A period of 20 to 25 years is envisaged for this purpose, to make the adjustment path bearable.

The hope invested in the debt repayment pact is that the yields on jointly guaranteed debts would be significantly lower than market interest rates if the right institutional arrangements were established. This would represent a considerable relief for Italy in particular and could enable it to get back onto a sustainable growth path and tackle budget consolidation prudently. For Spain the relief would be somewhat less because hitherto its debt level, at around 70 per cent, is only a little above the 60 per cent threshold (albeit increasing sharply). The volume of Spain's financing from the Fund would thus be comparatively low (see Figure 1). We shall now look at the pact in more detail.

3.1 Five Pillars of Strict Fiscal Discipline

In its proposal, the Council of Experts strongly emphasises that the structure of the jointly guaranteed debt should give no incentive for individual member states to unload the debt onto other member states. Five criteria were formulated for this purpose that must be met to obtain funds from the joint bond issues:

1. The introduction of national debt brakes is supposed to ensure that government debt really is reduced, thus disabling one possible trigger for speculation against EMU member states. Violations are to be punished by means of European supervision of compliance with these national debt brakes and lead to immediate payment by the affected country to the debt repayment pact. Central bank profits can be deferred for this purpose.

2. Medium-term paths for debt reduction can be established and supported by laying down national consolidation and growth strategies.

3. If a country fails to meet its obligations under point 2 in the course of the roll-in phase, the roll-in for this country can be terminated.

4. Participating countries must commit themselves to VAT and/or income tax increases, which will be used directly for debt repayment to the Fund. In addition, priority repayment of debts from the fund could be written into the constitution.

5. Part of national foreign exchange reserves are to be pledged (in the amount of 20 per cent of borrowings).

Under criteria 1 to 3 participating countries should be obliged as early as the roll-in phase to lay the foundations for long-term budget consolidation. Criteria 4 and 5 should bring it about that in the repayment phase additional funds are made available to cover repayments and thus help to further limit liability risk.

3.2 Contribution of the Debt Repayment Pact to Combating the Crisis

The proposal of a debt repayment pact can make an important contribution to overcoming the euro-crisis. However, it does have weaknesses and should, in particular with regard to boosting growth potential, be adjusted to the countries concerned.

A positive effect of the debt repayment pact is that Euro-heavyweights Italy and Spain would receive the requisite liquidity in the short and medium terms so they would not have to continue with austerity measures in the crisis and to limit the cost of their new debts. The interest-deadening effect derives from several sources:

1. A more liquid market would emerge from joint borrowing. Joint debt securities could be traded more easily by investors because of their larger market volume, which would tend to have an interest rate-reducing effect.[6] Market breadth could also be increased by not issuing the debt securities for the maximum 25-year term of the debt repayment pact. If the terms were limited to 10 years, as is already the case with regard to the bulk of national public debt, the market breadth for the securities would be approximately doubled. Repayment over 25 years would be possible nevertheless by further jointly guaranteed borrowing when the securities reach maturity (rolling them over on a smaller scale due to the repayment plan).

6. This is one of the key arguments for the interest rate–reducing effect of eurobonds; see Jacques Delpla/Jakob von Weizsäcker: The Blue Bond Proposal. Bruegel Policy Brief No. 3/2010.

2. Joint guaranteeing of the debts in the repayment fund by weaker countries and countries with higher creditworthiness, such as Germany and the Netherlands, leads to a lower credit default risk in comparison to the purely nationally guaranteed debts of Italy and Spain.

3. The priority servicing of joint debts formulated in the criteria and the pledging of foreign exchange reserves or central bank profits are also likely to keep interest rates down by again reducing the risk of default on joint debts.

The significantly reduced interest rates on their new borrowings would win crisis countries such as Italy and Spain up to five years' grace for growth-enhancing measures and reforms. Countries with considerable foreign trade surpluses, such as Germany and the Netherlands, if given more time could more easily contribute the economic dynamics in the Eurozone, since presumably their foreign trade surpluses could be reduced only with great difficulty in a short time (this requires structural changes in the economies concerned). The looming negative spiral of austerity policy and ensuing growth slumps in the Eurozone could thus be countered effectively. The provision of a comparatively secure fixed asset (the jointly guaranteed bonds) could also help stabilising the European banking sector.

Other proposals for resolving the euro-crisis currently under discussion, such as IMF participation in budget financing and leveraging the EFSF to finance partial coverage insurance of government debt, are less convincing. Stronger IMF participation would probably lead to higher risk premiums on government debt due to the priority status of IMF loans. Partial coverage insurance on government debts would indicate that the countries concerned, in the event of a financing bottleneck, would definitely be on their own to cope with it and there would be no interim aid. As a result, the likelihood of a payment default would be significantly higher – this too would be a reason for higher risk premiums. The incentives for austerity measures that exacerbate the crisis thus remain in the case of both stronger IMF participation and a leveraged EFSF. The debt repayment pact differs markedly from the measures to combat the euro-crisis implemented hitherto. On the one hand, one should mention the ongoing adjustment programmes involving Greece, Ireland and Portugal. Not only are they much more short-term than the debt repayment pact, but the countries concerned have to pay much higher interest rates (over 5 per cent).[7] The strict conditions imposed by the IMF and the EU also lead to austerity measures that only exacerbate the crisis. The tightened-up Stability and Growth Pact (see the remarks on the Sixpack in Section 2) starts out similarly, especially with regard to budget consolidation. In the event of rigid implementation the heightened stringency and accelerated procedure could further exacerbate European growth problems in the current troubled economic environment, in particular if the austerity measures are imposed everywhere in the European Union.

The same applies to the decision taken at the EU crisis summits in December and January to introduce national debt brakes in all the Eurozone countries. Here the choice of adjustment path and the assumptions made in calculating the structural deficit are extremely sensitive. Too restrictive assumptions with regard to tax elasticities and the level of the automatic stabilisers could easily cause the debt brakes to have a procyclical effect.[8]

3.3 Need to Adapt the Debt Repayment Pact

Basically, the Pact manages to strike a balance between short-term relief as regards refinancing by crisis-hit states and prudent and long-term budget consolidation. However, the Pact also exhibits a few significant weaknesses that need to be corrected.

First, the Pact should not reinforce the current trend towards drastic and counterproductive austerity efforts. That would represent no improvement over how things are already. To ensure progress, the annual debt reduction envisaged by the Council of Experts of 5 per cent of public debt over the 60 per cent level should not be applied too rigidly, but in accordance with a country's specific economic outlook. Another disadvantage of the proposal is that practically all countries would be subject to a debt repayment programme because almost all euro-countries have national debts above 60 per cent of GDP. As a result, every country would be subject to austerity measures, thereby further exacerbating the growth-dampening spiral. Hitherto, states such as Ger-

7. See Rainer Lenz (2011): Die Krise in der Eurozone: Finanzmanagement ohne Finanzpolitik, Friedrich-Ebert-Stiftung, June 2011.

8. In particular, the German version of the debt brake appears to be affected by this; see Gustav A. Horn, Torsten Niechoj, Achim Truger, Dieter Vesper and Rudolf Zwiener (2008): Zu den Wirkungen der BMF-Schuldenbremse, IMK Policy Brief, May 2008.

many, despite having debts above the 60 per cent mark and pursuing a moderate course of austerity, have been able to function as growth-engine for the Eurozone. Germany could, for example, by boosting domestic demand, help to stimulate demand to the benefit of other euro-countries which at least partly offset their lower growth. In order to avoid a concerted euro-austerity policy the pace of general government debt reduction should not be binding on all states with debts over 60 per cent, but rather for an appropriate selection. Stronger countries with foreign trade surpluses, such as Germany and the Netherlands, would probably obtain no interest-rate benefit from the debt repayment pact, anyway, so there would be little incentive to submit to all of its regulations. In any case, these countries have a comparatively low debt dynamic.

A key institutional weakness of the Pact is the uncertainty concerning whether the rules will be complied with over the long period of 20 to 25 years or considerably diluted. Thus it is not unlikely that a country will abandon the particular debt repayment path it set out on after a number of years for a less demanding one. This could diminish the Pact's institutional credibility. On the other hand, laying down in the first year a binding and inflexible repayment path for the next 20 years, from which no subsequent deviation is possible, is ruled out. The business cycle and global economic environment could necessitate an adjustment of the repayment path over time. This problem can be resolved credibly only if the debt reduction target is fixed for 20 years, but some scope for short-term relaxation (with the repayment path subsequently being speeded up) must be possible. Only in this way can a debt repayment path with breathing space be ensured.

In parallel with debt repayment the Pact must provide for a concrete growth strategy for each country. Only a combination of sustainable financial policy and a strengthening of the forces driving growth can safeguard lastingly low bond interest rates and robust growth prospects. A growth strategy should therefore imply that countries have privileged access to the resources of the EU Structural Funds. Depending on the debt level at the beginning of the repayment programme a certain portion of the available Structural Funds should benefit the country.

A European investment programme can also help in combating the growth defects of the crisis countries. This should be tailored to countries' specific needs. Thus, in Greece, for example, support should be provided for industrial locations and business start-ups to overcome its lack of competitiveness. In Portugal, spending on education is urgently required: the rate of those leaving school without qualifications is 37.1 per cent – in Germany, the rate of 2.8 per cent is already considered much too high. Overall, an investment programme must put money into infrastructure, education and R&D. The investment programme could be financed by increasing the EU budget. Such programmes should comprise a mixture of short-term economic stimulus measures and long-term structural aid.

4. Outlook: Prerequisites of Long-term Budget Consolidation in the Eurozone

Whether the repayment of debts envisaged in the debt repayment pact for the period after 2016 is managed over a 20–25 year period is likely to depend on a number of factors. First, in every economy paying down public debts requires correspondingly lower savings – or higher debt – on the part of the private sector and/or other countries.[9] An increase in indebtedness of other countries is likely to be out of range for the Eurozone overall because it would be accompanied by an improvement in the current account balance of the whole Eurozone. Overseas countries – in Asia, the United States and so on – would have to be willing to buy significantly more goods and services from Europe. The data show, however, that many emerging countries are also trying to strike out on this development path and the United States already have a major problem with excessive current account deficits. What is difficult for the Eurozone as a block is nevertheless a condition of sustainable recovery for the Southern member states. The euro-crisis illustrates that lasting current account deficits and thus increased external debt may trigger abrupt withdrawal of capital – right through to flight out of government debt securities. The Southern countries should thus strive to improve their current account balances by exporting more to the rest of the Eurozone and overseas.

Successful public debt repayment would bar the way for more competitive Northern countries to further increase

9. For a description of this identity see M. Brecht, S. Tober, T. Van Treeck and A. Truger (2010): Squaring the Circle in Euroland? Some Remarks on the Stability and Convergence Programmes 2010–2013, IMK Working Paper 3/2010.

their exports. In the event that the Eurozone is stabilised they would have to live with a relative loss in price competitiveness and export markets since the Eurozone as a whole will be able to export less rather than more if the crisis is overcome.[10] In these circumstances, public debt repayment requires mainly lower savings or heightened private sector debt. This can work in particular in the event of robust economic growth if enterprises expand their borrowing to finance investment. Where governments are in a position to do so, they should thus support domestic growth in the Eurozone's export countries. Innovative approaches to supporting the economy, redistribution measures – such as minimum wages – and an effective state spending policy could contribute to this. One European institution in particular is likely to enjoy much higher status than before the financial crisis: the European Central Bank will be a critical factor in properly developing the Eurozone's monetary mantle of growth. Its interest rate policy gives the ECB the means to encourage business investment. There would be no need to limit its autonomy for this purpose. However, the ECB mandate should be extended by European legislation to include an explicit growth target on a par with the goal of price stability, on the model of the US Federal Reserve.

Undoubtedly, there is a possible conflict of aims between boosting growth and limiting price rises. This conflict is the object of a long-standing economic debate on the trade-off between unemployment and inflation. More recent research shows, however, that, depending on the relevant labour market institutions, there is scope for using monetary policy to boost growth.[11] With a dual mandate, the ECB, like the Fed, would have to find a constructive approach to this problem. In the current situation, with an ECB mandate focussed primarily on price stability, it can be doubted whether a constructive approach is possible in the EU with this trade-off. Germany provides a good illustration. While the ECB's bond purchases and subsequent long-term refinancing operations (LTFO) so far are already considered to pose a major threat to price stability there, elsewhere in Europe there are worries about the continuance of the Eurozone should ECB participation in combating the crisis not prove possible in the last instance. The debt repayment pact, by contrast, foresees no further bond purchases by the ECB. The prospects of success with regard to the consolidation envisaged by the debt repayment pact, however, depend decisively on the other conditions for growth. Ultimately, it is up to the politicians to support the ECB with an appropriate mandate.

10. This is a consequence of the so-called Triffin-Dilemma, according to which countries with a successful reserve currency experience enhanced international demand for their assets. Long term, therefore, successful euro stabilisation would probably lead to appreciation and, consequently, to a current account deficit for the Eurozone as a whole.

11. On this subject, there are a number of neo- and post-Keynesian contributions that start out from alternative specifications of the Philips curve; see Akerlof, G.A., Dickens, W.T., and Perry, G.L. (2000): Near-Rational Wage and Price Setting and the Long Run Phillips Curve, Brookings Papers on Economic Activity, No. 1: 1–60; also Pusch, T. (2009): Policy Games: die Interaktion von Lohn-, Geld- und Fiskalpolitik im Lichte der unkooperativen Spieltheorie, Lit Verlag, Zürich (combined with a game-theoretical argument). Also arguing from a game-theoretical standpoint, Dullien, S. (2004): The Interaction of Monetary Policy and Wage Bargaining in the European Monetary Union: Lessons from the Endogenous Money Approach, Palgrave Macmillan (inter alia).

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