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Debt Redemption Fund: Conditio Sine Qua Non?

Government Bonds in the Euro Area Crisis

Abstract

Fiscal austerity has not led to a return of confidence and it is not at all certain that the current crisis strategy can be sustained politically and will eventually succeed. Government bonds of crisis-hit countries have lost their safe asset status and high risk premiums are impairing monetary transmission. Within its mandate the ECB is in principal able to do what it takes to put an end to this crisis, but only if euro area governments tow the same line. A well-designed debt redemption fund could restore confidence and enhance growth by repairing the monetary transmission mechanism and allowing the expansionary monetary policy of the ECB to reach the crisis-hit countries. Combined with additional policies to foster growth and rebalancing in the euro area, a temporary debt redemption fund could be instrumental in engineering an economic turn-around. The paper touches upon the recent OMT-decision of the German Federal Constitutional Court, euro(basket)bonds and eurobills.

Keywords Debt Redemption Fund, OMT, safe assets, TARGET2, constitutional court, current account imbalances.

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Introduction

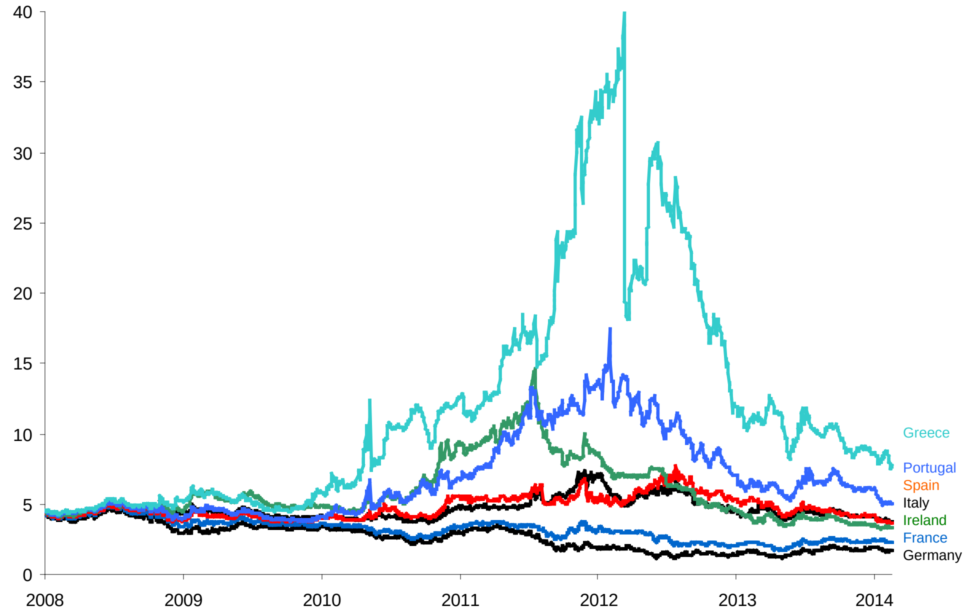
In early July 2013, the EU Commission set up an expert group to analyze the feasibility of a debt redemption fund as a means of ending the euro area's current woes (EU Commission 2013). The main purpose of such a fund – initially proposed in 2011 by Vincente Visco (Parello/Visco 2012) and the German Council of Economic Experts (2011) – is to bring down risk premiums in the crisis-hit countries thus creating a precondition for these countries to return to a path of economic growth and low unemployment.

The idea of a debt redemption fund first gained ground in 2011 and 2012 when yields in many euro countries were rising to very high levels in the midst of recession. Ten-year government bond yields increased drastically in Greece, reaching 40% prior to the 53% haircut on private holdings in March 2012 and, soon after, climbed yet again to reach 28% in the latter part of July 2012. At that time, ten-year government bonds yields of Italy, Spain and Portugal peaked at 6.6%, 7.6% and 11.4%, respectively (Chart 1).

Rates have since come down substantially and the euro area appears to be on its way out of recession. Given these improvements, is a fund based on the joint and several liability of all euro countries and thus involving considerable risk-taking still warranted?

Chart 1

10-year government bond yields of selected euro area countries, daily, in %



Source: Reuters EcoWin (EcoWin Financial).

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In this paper I argue that a debt redemption fund is as important for restoring economic stability to the euro area as when initially proposed two years ago. Although the readiness of the ECB to engage in outright monetary transactions (OMT), announced in September 2012, has decreased denomination risk and added a second emergency facility to the limited stabilization capabilities of the European Stability Mechanism (ESM), the euro area economy continues to be fragile. It is not at all certain that the current crisis strategy can be sustained politically and will eventually succeed. This is all the more so as the German Federal Constitutional Court has recently called in question the legality of OMT (Box).

Primarily as a result of the loss in confidence and the fiscal austerity attempts to regain it, unemployment in the most troubled euro area economies of Spain and Greece is at 26% and 28%, respectively, and youth unemployment close to 55% and 60%.[2] The monetary transmission mechanism, although improved, is still far from running smoothly, loan rates in the troubled countries are elevated and bank balance sheets saddled with low-priced government securities and non-performing loans. The longer the crisis last, the more hysteresis effects are likely to take hold and diminish potential output (Horn et al. 2007).

A debt redemption fund appears to be the most practical solution to these problems. A decisive measure such as this one is necessary for the euro area to avoid risking lasting hardship for millions of citizens, political turmoil and the realization of potential losses contained in the skewed refinancing loans of the Eurosystem (and mirrored in the Target2 balances), in the Eurosystems' bond purchases and in the stability loans granted by governmental institutions.

Flawed crisis analysis

The euro crisis began in 2009/2010, when Ireland, Greece, Portugal, Spain and Italy were faced with the erosion of the safe asset quality of their government securities. This loss of confidence was not the result of profligate government spending but of unsound macroeconomic policies in many euro countries that caused a buildup of macroeconomic imbalances within the euro area.

If nominal unit labor costs in the euro area countries had risen in line with the ECB's inflation target of 1.9% between 1999 and 2007, they would have increased by a total of around 18%. This was only the case in France, however. In Greece, Portugal, and Spain, unit labor costs increased by 26%, 27% and 31%, respectively; in Germany, by contrast, they declined by 1% during the same period. Inflation rates similarly diverged, albeit less pronounced.

One of the most vocal critics of the currently high TARGET2-balances within the Eurosystem, Hans-Werner Sinn, was among those economists who argued that inflation

[2] December 2013. Unless otherwise noted, the source for economic data is Eurostat and the AMECO database, last updated November 2013, the source for monetary data are the national central banks of the Eurosystem and the ECB.

differentials did not constitute a macroeconomic problem because Spain allegedly was in the process of economic catch-up which necessarily results in higher inflation in the service sector (Sinn/Reutter 2001).[3] However, above-average inflation rates in Spain, in Portugal, in Greece, and in Ireland were not harmless side-effects of economic catch-up but rather signs of economies overheating: Productivity increases in industry and manufacturing were not particularly large.[4]

The consequence was a marked shift in international competitiveness within the euro area. The euro area was divided: On the one side were countries such as Greece, Portugal and Spain with strong domestic demand, surging imports and rising trade deficits, on the other stood in particular Germany with weak domestic demand, rising net exports and expanding current account surpluses. By 2007, the Spanish and Portuguese current account deficits had climbed to 10% of GDP, the Greek deficit amounted to 17% of GDP, whereas Germany and the Netherlands had large current account surpluses of 7.5% and 8.4% of GDP, respectively. The upshot was rising foreign debt in the countries now in crisis, albeit not as a result of lavish government spending but, in most cases, as a result private investment and consumption expenditures.

To prevent macroeconomic imbalances within a monetary union, all countries need to keep their macroeconomic developments in line with the central banks inflation target. Country-specific developments such as inflation-increasing or -decreasing growth cannot be checked by monetary policy but must be contained using domestic fiscal policy measures.

Not only did euro area countries fail to coordinate their policies in this very rudimentary fashion but, in addition, there were no early-warning systems in place which could have prompted European institutions to call for adjustment. The early warning system focused primarily on the fiscal deficit. However, between the introduction of the euro in 1999 and 2007, when the international financial crisis erupted, Spain, for example, had reduced its government debt ratio from 62% to 36% of GDP and in all but one year would have satisfied even the strict fiscal deficit target of the Fiscal Compact, adopted by the euro area countries in 2012.[5] Similarly, Ireland reduced its public debt ratio from 47% of GDP in 1999 to 25% of GDP in 2007.

It was not a lack of adherence to the rules of the stability and growth pact (SGP) that lies at the root of the current crisis but a misspecification of this pact. Therefore, it is not quite

[3] A country that catches up on the productivity advances experienced in other countries has above-average productivity growth in industry and also a more rapidly rising wage level in that sector. If wages in the service sector also rise faster even though its productivity increases are not high, inflation increases without signaling impending imbalances. This phenomenon is called Balassa-Samuelson effect.
[4] Lommatzsch/Tober 2003 and Lommatzsch/Tober 2006.
[5] This is the case from a real time perspective, which is the relevant one when evaluating whether policy targets are met. Ex post, structural deficits have been revised upward substantially in line with the downward revision of potential output estimates.

accurate when a lack of fiscal constraint is identified as a stylized fact of crisis genesis as, for example, by ECB President Trichet in September 2010:

„There is a permanent under-assessment of what is necessary in this domain, particularly in the euro area. That is why our message is always the same. Even in 2004 and 2005 we had to fight to maintain and preserve the Stability and Growth Pact, which was considered an abnormal, excessive constraint on fiscal policies. Now we are observing what has happened and I think everybody knows that it is extremely important." (Trichet 2010)

Granted, in 2004 and 2005 Greece, Italy and Portugal violated the SGP, but so did Germany and France, whereas Ireland and Spain had fiscal surpluses averaging 1.6% and 0.6% of GDP, respectively. What the crisis-hit countries had in common were large current account deficits.

It follows that not only the troubled countries need to "do their homework" but all euro area countries, including those with large current account balances. The macroeconomic imbalance procedure in place since late 2011 is therefore an institutional step in the right direction.

Furthermore, it is not a viable option for all countries to follow Germany's lead and increase their international competitiveness. Price competitiveness is a relative concept so that within the euro area this would be impossible by definition, implying that the euro area as a whole would have to run a current account surplus thereby merely shifting the problems to a different level.

Special asset status of government bonds

The existence of domestic safe assets is an important characteristic of developed economies. "Safe" assets are as close to being risk-free as one can get in the real world. They add stability, being a reliable store of value as well as an important component in the regulation of banks and serving as benchmarks for pricing other assets and as collateral (International Monetary Fund 2012a).

Government securities are the obvious safe asset, because firstly, governments unlike other economic agents can favorably affect the economic environment by implementing prudent macroeconomic policies, and secondly, government debt is ultimately backed by the entire national economy because governments have authority to tax. Furthermore, the national central bank can act as market maker in the case of slackening demand for national government securities. Similarly to price level stability, "safe" government bonds are a stability anchor of the economy, reducing the level of economic uncertainty and increasing the effectiveness of macroeconomic policy.

The status of government securities as safe assets implies that risk premiums are low or absent and thus interest rates are relatively low. This is a big plus for tax payers and allows for public investment at low funding rates. For example, the yield on ten-year government bonds in Japan averaged only 0.9% in June 2013 even though gross government debt is expected to reach 244% of GDP in 2013. U.S. government bonds with a remaining maturity of ten years carried a relatively low yield of 2.3% despite a debt ratio of 111% (2013).

Many characteristics make government bonds the obvious safe asset of an economy. Gaining and maintaining this special status is nonetheless anything but a foregone conclusion. It precludes that debt restructuring, “haircuts” or inflation are viewed as part of the standard economic policy toolkit. Otherwise higher risk premiums are likely to take hold, to the detriment of society as a whole.

Reluctant lone ranger: ECB to the rescue

As confidence in the store-of-value quality of the government securities of Greece, Ireland and Portugal faltered in early 2010, the response of euro area governments did not calm markets. To contain financial market turmoil, ECB initiated a government bond purchase program, buying securities of these three countries worth 78 billion euros until early 2011. In July 2011 the crisis threatened to spiral out of control, as discussions of private sector involvement and haircuts caused the crisis to engulf Italy and Spain – a development the ECB had warned about and had tried to prevent (ECB 2011, The Economist 2010). The ECB embarked on a second round of government bond interventions bringing up its policy-motivated government securities’ purchases to 219 billion euros in early 2012.

Governments failed to assert the safe-asset quality of all euro area government securities but instead praised the disciplinary role of interest rate differentials and drafted a debt haircut for Greece. In response, the ECB shifted its focus away from risky government securities to the no less risky banking sector. In early December 2011, the ECB announced two refinancing operations for credit institutions with the historically long duration of 3 years. Given large-scale capital flight from the crisis-hit countries, inaction on the part of the Eurosystem would have likely led to widespread bank failures, severe financial market turbulence and even the break-up of the euro area. The Eurosystem significantly increased its refinancing and emergency loans to banks. The level peaked in late June 2012 at 1447 billion euros, a three-fold increase compared to the pre-crisis level in mid-2007. 70% of these refinancing loans went to Greece, Ireland, Italy, Portugal and Spain, which in 2007 had accounted for only 15% of the total.

The arrears between the euro area’s national central banks increased in almost equal magnitude,[6] showing the extent to which the ECB’s attempts to forestall a collapse of the euro area allowed private investors to shift their risks to the public sector: The Target2 liabilities of Greece, Ireland, Italy, Portugal and Spain reached almost 1000 billion euros in the summer of 2012, while Germany had corresponding assets of above 700 billion euros (Chart 2).

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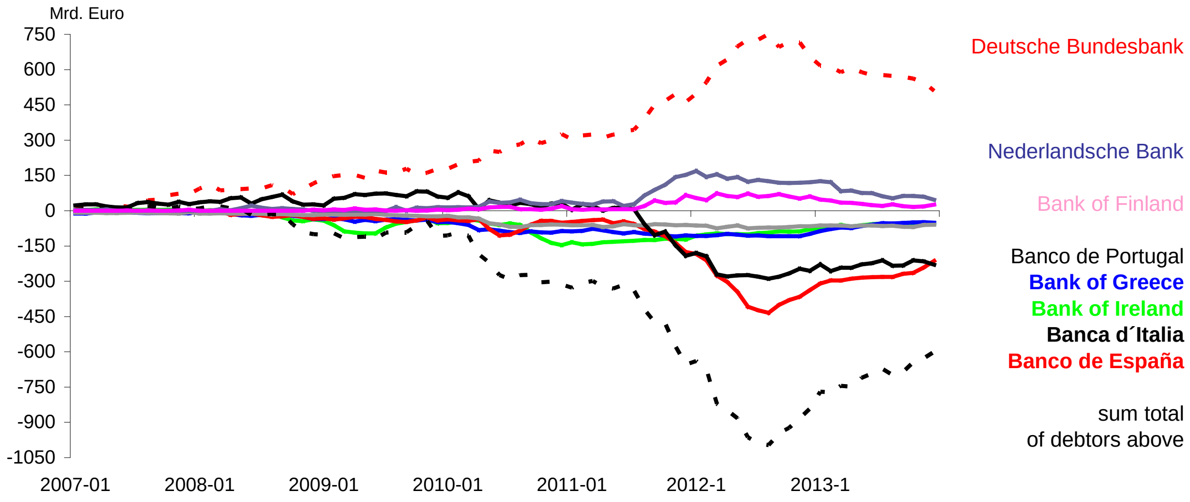
[6] These assets and liabilities between national central banks of the euro system result from cross-border transactions and are transformed into arrears vis-à-vis the ECB at the end of each day. They are called Target2 assets and liabilities because of the name of the interbank payment system in the euro area: **T**rans-European **A**utomated **R**eal-**t**ime **G**ross **S**ettlement **E**xpress **T**ransfer System.

Chart 2

Target2 Balances within the Eurosystems, January 2007 – December 2013



Source: National Central Banks.

It was during this most recent acceleration of the crisis that the ECB came to the rescue once again and, in early September 2012, announced that it would, under certain circumstances, purchase government bonds in unlimited amount, a procedure called monetary outright transactions (OMT). So far, the program has not been activated, but the announcement alone has substantially brought down risk premiums from their peak levels (Chart 1). The ECB did not, however, vow to eliminate yield spreads on euro area government bonds. Yields are still high in the crisis-hit countries and the monetary transmission channel remains impaired.

Restoring confidence: Current policy strategy inadequate

One could argue that Greece was not a developed industrial nation when it joined the euro area in 2001. Be that as it may, for reasons mainly beyond the realm of economics, Greece did become a member of the euro area. The integration of Greece could have been successful, if the great advantages of lower long-term interest rates and stability had been used more wisely and other countries in the euro area had not contributed to the emergence of macroeconomic imbalances.

Given that Greece is part of the euro area and a breakup of the euro area is not on the political agenda, it is often maintained that eurobonds, a fiscal union with built-in transfers between countries and a full-fledged banking union are necessary to strengthen the euro area. These changes would be very far-reaching and deserve careful consideration. They are not, however, a prerequisite to restore stability und prosperity.

To restore stability und prosperity in the short-term, a temporary debt redemption fund would suffice. The debt redemption fund could restore confidence and enhance growth by repairing the monetary transmission mechanism and allowing the expansionary monetary policy of the ECB to reach the crisis-hit countries.

Combined with additional policies to foster growth and rebalancing in the euro area, a temporary debt redemption fund could be instrumental in engineering an economic turn-around. In the medium term, stability would be enhanced if policy makers kept a close eye on inflation and, if necessary, used fiscal policy to steer the economy back on track. Bank regulation limiting the size and risk-taking capabilities of individual institutions would add stability to the financial sector.

In contrast to proposals of a debt redemption fund, the current crisis strategy is based on slowly regaining the trust of investors through fiscal austerity. This strategy has proved ineffective and counterproductive.[7] To make matters worse, the distrust of investors is currently viewed by policy makers as a mechanism to discipline governments and quell their insatiable desire to spend money.

However, the international financial crisis clearly showed that financial markets react late and exhibit herd behavior. Instead of being a disciplinary force, a loss of investor confidence can trap a country in a vicious cycle of higher financing needs, austerity measures, declining growth, a further loss of confidence, and banking troubles. Chancellor Merkel's insistence on private sector involvement sparked the first wave of contagion in October 2010. The announcement of a write-down of privately held Greek government bonds led to a new peak in yields and the spreading of the confidence crisis to Spain and Italy in the summer of 2011.

Similarly, the ESM treaty is likely to undermine the safe-asset quality of government securities and increase the risk of future speculative attacks by prescribing government bonds to carry collective action clauses that regulate private sector involvement in case of payment difficulties. Collective action clauses are usually only included in foreign-currency government bonds because these carry exchange rate risk and governments might not be able to attain the foreign currency necessary to service foreign-currency debt. However, euro area countries have now adopted this practice for bonds denominated in the currency that they collect as taxes.

[7] In 2012, the IMF (2012b) argued that front-loaded consolidation may be counterproductive in a crisis with low inflation and low interest rates because fiscal multipliers may be substantially higher than previously estimated. The OECD argues that the crisis strategy did not produce the expected results because governments failed to bring down interest rates in the crisis-hit countries (OECD 2014).

Box: The German Federal Constitutional Court on Outright Monetary Transactions

The German Federal Constitutional Court in early 2014 expressed its opinion on the legality of Outright Monetary Transactions and, ultimately, of purchases of government securities by the Eurosystem, in general.[8] A formal ruling can be expected in 2015 once the European Court of Justice, to which the case was referred, has taken a stand.

The majority of the judges – two of the eight judges contend that the case should have been dismissed – conclude that substantial reasons support the argument that OMT is in conflict with both the EU treaty and the German constitution in that

> „… it exceeds the mandate of the European Central Bank and thus transgresses into the competence of member states for general economic policies as well as violating the prohibition of monetary financing of governments.“[9] BVerfG, 2 BvR 2728/13, 14.01.2014

The court states its case around 10 keywords: conditionality, selectivity (of purchases), parallelism (to ESM), circumvention (of aid programs), no limitation, no time interval (primary vs. secondary market), held to maturity, no credit rating requirements (credit risk), same treatment in case of debt restructuring (pari passu) and impact on pricing (encouraging primary market purchases).

The first four are viewed as indicating that the ECB is overstepping its mandate (ultra vires act), the latter six as violating the prohibition of monetary government funding (Art. 123, Lisbon Treaty), which would, in itself, be a breach of the ECB’s mandate.

The main arguments are that the objectives of OMT are not related to monetary policy but to wider general economic policy, that OMT constitutes monetary funding of governments and that it bears considerable risks which impinge on the national parliament’s fiscal authority.

[8] **Outright Monetary Transactions** (OMT) refer to a decision of the ECB in September 2012 to under certain circumstances engage in secondary market government security purchases to safeguard “an appropriate monetary policy transmission and the singleness of the monetary policy”. Not activated so far, OMT would extend only to securities of euro area countries that apply for a EFSF/ESM program and be limited to the shorter part of the yield curve (1-3 years), but not in size. (http://www.ecb.europa.eu/press/pr/date/2012/html/pr120906_1.en.html)
The **Eurosystem** comprises the European Central Bank (ECB) and the national central banks of those countries that have adopted the euro.
The **decision** of the German Federal Constitutional Court (BVerfG, 2 BvR 2728/13, 14.01.2014), published on 7 February 2014, is found under http://www.bverfg.de/entscheidungen/rs20140114_2bvr272813.html.

[9] Translated from German. Original quote: „… dass er über das Mandat der Europäischen Zentralbank für die Währungspolitik hinausgeht und damit in die Zuständigkeit der Mitgliedstaaten übergreift sowie gegen das Verbot monetärer Haushaltsfinanzierung verstößt.“ Bundesverfassungsgericht, Press Release Nr. 9/2014, 7. February 2014.

The ECB, in my opinion, justifiably argues that the objective of OMT is to safeguard effective monetary transmission in the euro area. If doubts about the composition of the euro area drive up risk premiums, then overall interest rates rise in those countries viewed as potential exit candidates, thus impairing the singleness of monetary policy. Contrary to the assertion of the court, a selective approach is not indicative of a non-monetary policy objective, but rather necessary to achieve the monetary-policy objective. Buying government securities of all euro area countries would do little to remedy the divergence in yields. Furthermore, the aimed-at reduction in interest rates would indeed positively affect the interest burden of governments but as a by-product, not an objective.

The legality of potential risks incurred and their possible impact on government finances can, in my opinion, be discussed only in junction with the mandate of the ECB. Central banks regularly take on risks in pursuit of monetary policy objectives. If the ECB is within its mandate, it would likely not fall within the mandate of the German Constitutional Court to decide on the nature and size of risks incurred.

A key question is, therefore, whether the ECB acted within its mandate. As argued in this paper, the OMT decision is one of several examples where the ECB came to the rescue when governments failed to take decisive action. In this sense, the court has a strong case when arguing that

> „The OMT decision can … not be justified as a measure to support general economic policies of the Union.“ [10]
> BVerfG 14.1.2014

Nonetheless, as minority-opinion judge Gerhardt points out, governments did endorse the ECB's action,[11] which again calls in question the potential role of the German constitutional court.

The constitutional court deems it possible that the technical features of OMT might be modified in such a way as to eliminate the conflicts it identifies with respect to the EU treaty and the German constitution. In this paper an alternative solution is proposed. In line with the court's assertion that the possibility of debt restructuring must be excluded, a debt redemption fund is seen as an important ingredient for solving the currently unclear divide of responsibilities and eliminating a key factor of instability in the euro area.

[10] Translated from German. Original quote: „Der OMT-Beschluss dürfte sich daher auch nicht als Maßnahme zu Unterstützung der Wirtschaftspolitik der Union rechtfertigen lassen“ (BVerfG, 2 BvR 2728/13, 14.01.2014)

[11] „Wenn - um beim Fall zu bleiben - die Bundesregierung das OMT-Programm billigt und in die Grundlagen ihres eigenen Handelns einbezieht und der Deutsche Bundestag all dies sehenden Auges - vor dem Hintergrund einer intensiven öffentlichen Debatte, nach Anhörung des Präsidenten der Europäischen Zentralbank und ausweislich der Auskunft eines Mitglieds des Haushaltsausschusses des Deutschen Bundestages in der mündlichen Verhandlung aufgrund Beobachtung und Bewertung des Handelns der Europäischen Zentralbank - hinnimmt, liegt darin die Ausübung seiner demokratischen Verantwortung.“ (Gerhardt, BVerfG, 2 BvR 2728/13, 14.01.2014.)

Debt redemption fund: Way out of the crisis

A debt redemption fund[12] is a clever idea in the sense that joint guarantee is extended to that part of the debt financial markets may have doubts about, i.e. the national debt in access of 60% of the national GDP. If well designed, confidence would return rapidly and national interest rates would decline not only for government debt but for private loans as well.

All euro area countries would be jointly and severally liable for the debt guaranteed under the debt redemption fund. The responsibility for servicing the debt would remain with each individual country. An indispensable feature of this debt redemption fund would be that the guaranteed debt is retired within the predetermined life span of the fund, e.g. within 25-30 years.

The debt redemption fund proposal does not envisage a mutulization of debt. It does not involve financial transfers between euro area countries. It does not identify any culprits in causing the current crisis. The sole objective of the debt redemption fund is to restore confidence and allow the euro area as a whole to exit the crisis.

Key technical features are roll-in phase, country eligibility, funding and lending modalities of the DRF as well as the starting point and modality of debt repayment.

A roll-in phase has the advantage that the debt does not have to be converted into guaranteed debt all at once but over a period of time. This could result in lower refinancing costs.

To reap the full potential of the DRF in stabilizing the economy, all euro area countries should be eligible and obliged to join. In contrast, excluding those countries currently in an adjustment program – as proposed by the German council of economic experts – would imply that those countries most in need of lower nationwide interest rates would profit the least.

The DRF does not require paid-in capital but would be based on guarantees, similar to the European Financial Stability Fund (EFSF). Paid-in capital would furthermore not improve the rating of the Fund because the construction is one in which each country is jointly and severally liable. In contrast, for both EFSF and the European Stability Mechanism (ESM) member states are only liable for a part of the debt (roughly amounting to their GDP share).

The refinancing costs of the DRF should be roughly equal to those of German government securities minus the (negative) crisis premium Germany currently enjoys. Even EFSF issued bonds in 2012 yielded only slightly more than comparable German government securities.

When should a country start repaying its debt and by which predetermined process should the annual installments be made? Debt repayment presupposes one of two things or a combination thereof: either the respective country has a budget surplus corresponding to the repayment installment or GDP growth is such that keeping the non-guaranteed national debt at 60% of GDP yields sufficient new funds to cover the installment.

[12] The label European Redemption Fund is less fitting as European governments do not have to redeem themselves but rather their debts.

To give an example, let’s take Spain and assume that real GDP growth averages 1.2% during the next 25 years and inflation 1.6%. In 2014, Spain starts off with a debt ratio of 99%. If Spain had a balanced budget, the debt ratio would decline to 50% of GDP within 25 years simply because nominal GDP increases on average by 2.8% during this period. Aiming instead for a debt ratio at 60%, Spain could run an average budget deficit of 0.8% and still fully pay back its DRF debt within the lifespan of the fund. The key problem is the fiscal deficit Spain and other crisis-hit countries are facing and that is still increasing their debt ratio, and in particular, the “structural” deficit that remains even if the economy picks up. However, the larger the output gap really is and the higher future productivity growth, the lower will be this “structural” deficit. Furthermore, with the output gap closing, an increase in tax rates, a temporary wealth tax and privatization proceeds can serve to fill the financing gap of governments. Countries in a less troubled position and with current-account surpluses could contribute to stabilizing internal demand within the euro area by boosting domestic demand. Even with a modest average growth rate of 1.2% and an inflation rate of 1.9%, Germany could run an average budget deficit of 1.3% per year and still reach the 60% debt ratio within 25 years.

Repayment should commence three years after the fund is established. Ideally, the DRF would, however, buy long-term bonds of the member states immediately and refinance them long-term with an emphasis on ten-year bonds, thus creating a very liquid market segment of safe assets. The stressed euro countries would then immediately benefit from lower interest payments. Bonds due within this period would be refinanced by the respective national government.

Assuming the DRF is established rapidly and combined with growth-fostering macro-economic policies, the three years until repayment starts should be years of relatively vigorous growth as confidence not only returns to bond markets and the banking system but to entrepreneurs as well. In 2013, the debt ratios of all euro area countries increased and currently only two countries are expected to see a decline in 2014. In contrast, within the first three years of the new DRF-regime, all countries, except maybe Greece, can be expected to be in a position of declining rather than increasing debt ratios.

Notwithstanding the anticipated positive internal dynamics in the euro area, euro-area macro policies have little impact on the rest of the world and shocks from international trade or international financial markets as well as other unforeseen events cannot be excluded. The question therefore remains, how to determine the installments by which the euro countries redeem their DRF debt.

The amount that has to be paid back on average each year can be easily determined by dividing the euro amount of the debt in access of 60% of GDP by 25 years, the number of years during which the debt must be fully repaid provided the lifespan of the fund is 28 years and repayment starts in the fourth year. Such constant euro amounts would, however imply declining installments in percent of (rising) GDP. The annual target should therefore be expressed in terms of GDP with a certain amount of flexibility depending on the state of the economy. If nominal GDP growth is higher than expected, repayment should be more swift, if growth falls short, repayment can be deferred. In a world of perfect knowledge, this would amount to determining the structural deficit or surplus each country should realize in each and every year. Given the difficulties in determining the structural deficit, governments should instead predetermine a path for government expenditure, or rather government expenditure not sensitive to the business cycle. Non-cyclical government expenditure should increase at a rate compatible with bringing government debt down to 60% of GDP within the 28 years of the Fund's existence.

It is conceivable that the euro countries decide in ten years' time that a liquid euro bond market has advantages for all member states and should be maintained. Conceivably, the DRF could then evolve to include new financing for countries whose public debt would otherwise fall below 60%. But that is neither the purpose of this proposal nor should such longer run issues be decided on in the midst of an economic crisis.

Many features included in the proposal of the German council of economic experts (2011) mainly serve the purpose of allying fears of moral hazard. These include pledging of foreign reserves, adherence to the fiscal pact and the possibility of ending the roll-in phase if conditions of the fiscal pact are not met. Although some measures to ensure repayment compliance may have merit, the case for moral hazard seems to be vastly overstated, in part due to – or rather mirroring – the flawed analysis of the genesis of the crisis. The euro area crisis was caused by flaws in its institutional architecture, especially a misguided early warning system, not by profligate government spending. It was also greatly aggravated by the global financial crisis. The focus of macroeconomic surveillance has now widened to include unit labor costs, inflation and current account balances. Gearing policies towards low unemployment, adequate growth, and low inflation, should be the most effective way of lowering the risk that individual countries will pursue self-serving national strategies to the detriment of other member states.

Alternative proposals: eurobonds, eurobills and burying the debt

Peter Bofinger (2013) recently proposed basket-eurobonds as a means of making monetary policy more effective and alleviating the euro area crisis. Basket-eurobonds would be issued jointly but without joint and several liability. Each country would be liable for only its share of the bond which could equal the GDP share or the share in total government debt. The interest rate would therefore include a larger risk premium. Bofinger proposes that countries with a debt ratio below the euro area average would get a discount on the interest rate whereas countries with above-average debt ratios would face a correspondingly higher rate. Given the reluctance of governments to guarantee each others debt, this proposal has the merit of initiating a liquid bond market that could add stability to the euro area. However, the issue of high risk premiums on national government debt is not resolved and may be aggravated if the risk of default on these bonds is perceived to increase as a result of basket-eurobonds and the ECB only accepts basket-eurobonds as collateral. Furthermore, if the ECB intervenes on the basket-eurobonds or uses this market segment for quantitative easing, it faces many of the problems currently associated with government security purchases. Granted, it would no longer intervene selectively, but that is arguably the least problematic aspect of these purchases. The ECB would still take on risks the governments are unwilling to assume.

This is a problem not encountered by the proposal of the Bruegel institute (Delpla/von Weizsäcker 2010). Eurobonds would be guaranteed jointly and limited per country to 60% of GDP (blue bonds). They would exist parallel to "red bonds" issued independently by each state for financing and refinancing needs in excess of the Maastricht limit of 60% and presumably carrying a higher rate of interest. This eurobond proposal provides a clear incentive for states to reduce their debt ratio. It may also have positive effects on the general level of lending rates in the crisis-hit countries because only government debt in excess of 60% is classified as risky rather than the entire national debt.

However, this proposal has some drawbacks. It ultimately implies that countries may default on that part of the debt not jointly guaranteed. The safe asset status of government securities is thus renegated which, in itself, is an element of instability. Furthermore, although bank balance sheets will improve to the extent that they receive eurobonds in exchange for national government securities, they will still be burdened with low-priced national government securities. The latter may further decline in value as a result of the seniority status of eurobonds.

Like the two Eurobond proposals, the eurobills scheme put forth by Hellwig/Philippon (2011) and Graham Bishop (2013) envisages a euro area with jointly guaranteed government securities but implemented in much smaller steps. The idea is to issue jointly guaranteed eurobills with a maturity of less than one year. The volume of eurobills would be limited to 10% of GDP but would, according to the authors, be able to satisfy the refinancing needs of the crisis-hit countries during the coming years. Like a debt redemption fund and eurobonds, the eurobills proposal has two objectives: to lower the interest burden of crisis-hit countries and to build up confidence, in particular the trust between "North" and "South". The savings on interest payments are estimated to amount to 10 billion euros in the case of Italy, for example. Eurobills can be viewed as a first step towards the fiscal mutualization of public debt.

Compared to a debt redemption fund, the intention behind eurobills is vastly more far-reaching, whereas the short-and medium-term effects on confidence are likely to be substantially smaller. The small intended volume of eurobills and the focus on short duration may but are unlikely to inspire sufficient confidence to bring down overall lending rates in the crisis-hit countries. By contrast, a debt redemption fund would have an immediate effect on confidence but its limited duration, albeit 25-30 years, defines it as a crisis resolution mechanism, not the harbinger of eurobonds, fiscal union or other far-reaching changes.

Charles Wyplosz (2013), on the other hand, proposes to deal with the government debt directly to alleviate the problems of the euro area. Specifically, he proposes that the ECB should buy a certain portion of government bonds and transform these into interest-free perpetual bonds to remain on its balance sheet. No matter how well hidden in the Eurosystems balance sheet, this exchange would still amount to a mutualization of debt, which is something euro area governments are even more reluctant to engage in than a guarantee of debt with a realistic prospect of interest earnings and repayment. The latter is the objective of a debt redemption fund.

In a nutshell

In late July 2012, ECB president Mario Draghi famously vowed to do whatever it takes "to preserve the euro", adding "and believe me, it will be enough" (Draghi 2012). And yes, within its mandate the ECB is in principal able to do what it takes to put an end to this crisis, but only if euro area governments tow the same line. Once governments decide to do everything it takes to preserve the euro, the ECB would not only be able to act but would actually be legally obliged to do so, unless this were to cause a conflict with the ECB's primary mandate of maintaining price stability.[13]

A debt redemption fund may not be a *conditio sine qua non* for the survival of the euro area. However, it is hard to conceptualize how the euro area could make rapid progress in reducing unemployment and increasing production without a prior significant reduction in government bond yields and overall interest rates in the crisis-hit countries.

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[13] "Without prejudice to the objective of price stability, it shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union as laid down in Article 3 of the Treaty on European Union." (Lisbon Treaty, Article 127)

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