

## **Solving the Greek crisis and the €-area doubts through an EU tool for increasing financial -market rewards and sanctions**

*Christian Ghymers,  
JVI, March 2010*

*There is no need to change the EMU architecture...*

The present € crisis – triggered by the unsustainable Greek fiscal path - reveals the fragile consensus that underpins the single currency. This is not so much the result of deep institutional defects in the EMU architecture but rather the logical consequence of the repeated failures to implement fully and to respect the basic rules for a sound and beneficial working of the €. This failure is mainly a responsibility of the Member States for big mistakes in their policy making leading them to violate recurrently the Stability and Growth Pact. But it is also a responsibility of the Commission for not daring to speak more loudly in due time and for not having issued on time the warning signals that the Treaty entrusted it to manage. The lack of broader surveillance exercises and the lack of enforcement mechanisms together with the insufficient independence of the Commission and its absence in national policy debates made impossible the completion and the maintenance of the necessary conditions for benefitting from an efficient single currency. Therefore, it is not the Treaty itself and the EMU architecture which should be questioned but the way it has been applied until now.

Although the responsibility of Greece fiscal indiscipline relies clearly upon national authorities and Greek citizens, the fact that most of the EMU members – including Germany<sup>1</sup> - have systematically behaved against the committed fiscal rules and discipline, explains why the Greek crisis is just the opportunity for triggering this inevitable deeper € crisis. Although the fiscal lack of discipline is the most visible aspect and a crucial one since it contributes to others, it is not the only perverse spillover which was not tackled at the supranational level, as it would have been done according to a fair application of the subsidiarity principle. This fundamental principle is generally used one-way only for impeding the EU (and Commission)'s role to extend while it must also work the other way around when spillovers created by decentralized national policies have to be internalized at the EU level. For example, the excessive competitiveness divergences which developed during the first decade of the €, reflect also a lack of effective coordination or common rules for preventing a sub-optimum result for the EU as a whole, in the interest of all its members. There is also a clear case for Commission initiative (and responsibility) in this field but this short note will be limited to the only fiscal issue.

---

<sup>1</sup> The difference between cheating with the figures (by falsification of the statistical record of the budgetary rules) as the Greek authorities did, and cheating with the Stability and Growth Pact and the Treaty itself (by refusing to apply them) as Germany and France colluded to do, is just a difference of method (degrees of transparency... and political weights!). The result is the same but the responsibility of big Member States and consequences are far worse than for Greece: the whole € area fails to enjoy the very much required sustainable stance for public finance and the SGP failed to impede the free-riding bias of the common currency. The Spanish case illustrates also the inability of the design of the SGP in case of an artificial budgetary surplus created by a temporary construction boom. So, the genuine cause of the present € crisis relies mainly on the failure/inadequacy of the SGP combined with those of the Commission surveillance procedures.

Those claiming that the Greek crisis shows the basic defect of a single currency without an “economic government” or a single fiscal policy, are merely ignoring the durable reality of the impossibility of a federal union in this patchwork of cultures and nations. Either they are moved by a dangerous Jacobin ambition to impose to others their own policy by trying to escape democratic control, or they pretend to merely ignore the existence of the prevailing constitutional order in all the Member States: in any democracy, a budget is a national annual law, and this cannot be changed by more coordination except by moving abruptly to the United States of Europe i.e. a total illusion for many decades or forever. Nevertheless, there exist solutions at hands without imposing any big institutional change: let’s simply enhance financial-market incentives by organizing easier market discrimination between fiscal policies (i.e. market sanctions) in order to make national self-interest to coincide with the shared €-area interests. With this minimum of convergence ensured through an agreed transparent organization of the national debt-issuance process, a single currency would become efficient and beneficial for all members in spite of keeping full responsibility for fiscal policies at the national level as the subsidiarity principle recommends in full conformity with national constitutions and the Treaty.

*...but only to enhance the financial-market discipline through a combination of an independent technical surveillance leading to a rating system discriminating national bonds in two categories...*

The present contribution proposes a durable solution to the difficulties for meeting and preserving the conditions required by the existing Treaty architecture for a successful single currency. This structured solution required the implementation of three principles for orienting ECOFIN decisions without any Treaty change but only practical accommodations of the existing procedures:

**First principle:** the existing institutional framework (which won’t be changed soon) has made clear that the Commission is unable to do fairly its job when the fiscal rules like the SGP depends excessively on “political decisions” in which the Council is judge and part. Even if strengthening the formal rules and the financial sanctions of the SGP would be politically possible, this would condemn the Commission (and the EU itself) to become even more the scapegoat, making the € and the EU even more unpopular; in the meantime (for many crucial years) there is a need for an strengthened surveillance triggering realistic, automatic sanctions. There is a solution without institutional changes but only through current ECOFIN decisions. The practicable option requires two complementary Council decisions:

- (i) to “outsource” the technical monitoring to a truly independent, technical body empowered with a clear mandate and accountability to both the European Parliament and the professional. In fact, this would mean making DG ECFIN a fully independent office working for the Commission under contractual mandate protecting its analytical and material independence, and renamed NECFIN (New Ecfin). The only difference would be that the Commission- in conformity with the Treaty - would decide if it follows the NECFIN proposals/recommendations and endorses its reports and analytical documents, or if it adapts or opposes them under its own political responsibility, the differences becoming directly visible. Indeed, both texts would be made public simultaneously, both bodies (Commission and NECFIN) would become

accountable for the differences, creating some “cooperative competition” between them, according to the detailed mandate which would be given by the Council to NECFIN under proposal of the Commission. All the existing procedural aspects would remain unchanged. However, it is clear that the transparency and dynamism of the policy making process would be significantly enhanced. Any discrepancy would be intensively scrutinized by the financial press, the think-tanks, the IFIs, and the international economist community, stimulating a broad public debate across the EU. In particular, the European Parliament would be entrusted to organize together with the European Commission in the context of its existing “Brussels Economic Forum” a public conclusion of the annual post-mortem assessment which would be set up. This assessment process of the technical analysis of NECFIN and Commission’s work, would be based upon systematic hearings the Monetary and Economic Commission of the EP would had organized during the year. In these hearings, the discrepancies between Council decisions, Commission positions and technical initiatives/analysis of NECFIN would be openly discussed.

(ii) To enhance “financial-market discipline” upon national budgetary policies through an subordination clause creating an immediate discrimination between those financing needs respecting the SGP and those other needs in excess of the Maastricht criteria. This system is simple to organize if it is launched progressively: it consists first in introducing a subordination clause by each Treasury of the € area for “splitting” national debt issuance in two categories: the labeled “SGP conform” (or first category) is given by NECFIN in accordance to the rating process made as a result of its (autonomous) technical surveillance in the context of the SGP (see (i) above) and a warranted priority among the creditors of each Member State is given by its respective Treasury but in a formal ECOFIN decision; the rest of the needs has to go to the markets with the disadvantage to be placed after honoring the first category. So an immediate spread in the yields will castigate the second category with respect to the first one, compensating the higher credit risk on the second one. This system allows for increasing the sensitivity of financial markets to the individual budgetary performance and opens a possibility of rewarding good Stability programs. Indeed, the NECFIN surveillance exercise would result in the possibility to upgrade the label of new bonds in the first category when a Stability program is technically adequate and on track. As expected and observed in the ten first years of the € area, EMU provided Member States with a strong incentive for “free-riding” since investor discrimination between € government bonds remained excessively limited and myopic. The SGP was supposed to make up for this risk; facts demonstrated that this compensation did not impede the free-riding while the link between credit-risk and yields on sovereign bonds became non-linear reacting too late when unsustainability is already present as shown by the Greek case. So spontaneous financial-market discipline was inefficient for preventing or correcting policies by being too weak and too late, and counterproductive by being too rigid (hysteresis) when adjustment takes place. There is therefore a case for intervention, not for counteracting markets but on the contrary for channeling them as a disciplinary tool able to create incentives for national policies with automatic positive rewards and negative sanctions. Furthermore, this system opens a dynamic process of development of a harmonized management of the debt issues in the future as explained below.

**Second principle:** the Greek crisis only announces other coming ones for the following “PIIGS”, making urgent a systemic solution at the EU level. On one hand it is impossible to violate the “no bailing-out” clause without putting at risk the consensus which backs the € existence, especially in the populist days we are entering again (this could even mean the end of the euro and of the single market), on the other the solidarity demand together with the worrying negative spillovers issued by the PIIGS’ mismanagements upon the rest of the euro-area (and the EU) are too costly for letting them to be solved by the wild markets. There is a need for an instrument able to cut unnecessary overshooting costs of the fiscal adjustment under highly adverse market conditions, while respecting fully the prohibition of any bail-out. The only option is providing a new tool for organizing tough conditional loans addressing the market perceptions and the public opinions.

**Third principle:** such an initiative combining no-bailing out with conditional financial assistance is feasible in the context of a modulation of the subordination clause thanks to the proposed credible NECFIN surveillance (and rating) introduced for all the Member States under the double decision of the first principle above organizing the splitting of national debt issuance. This conditional rescue package would follow successive steps:

- 1) Existing fiscal situation and prospects make increasingly painful and counterproductive the Greek financing conditions, putting at risk the adjustment process itself with a cost for the € and the EU. Therefore there is a case for EU intervention if this intervention increases the probabilities of successful adjustment with less negative spillovers. A strictly conditional loan by tranches integrated into the proposed subordination clause (see first principle (ii)) could create a better tool than the alternative IMF concessional loans since it consists basically in internalizing spillover from national policy.
- 2) Although in the general system of splitting in two classes of bonds, in the present circumstances, Greece like almost all the other Member States, would have presently no room for issuing new debt enjoying the first category label, the EU could authorize as a reward for adequate budgetary measures (and under strict conditions) the Greek Treasury (as other Member State under SGP Stability programs and excessive deficit procedure) to issue new bonds with a subordinate clause giving priority to the holders of these new bonds. The conditions would be to get a positive assessment from NECFIN and to submit an issuance plan by tranche upon which NECFIN approval would be required at each issuance step. While upgrading new bond issues, this system would downgrade the existing bonds value, creating a growing spread between the two categories of bonds. The advantage for Greece to accept this strengthened surveillance would be explicit and translated in implicit budgetary incomes brought about by the EU/NECFIN surveillance.
- 3) Since this first improvement in financial conditions would probably not be sufficient at the beginning of the budgetary adjustment, an additional tool could be explicitly created: an EU bond issuance, warranted by the 27 Member States, and getting a AAA rating would make cheap resources available for a concessional loan to Greece under the strict package of simultaneous conditions: (i) a strengthened subordination clause favoring the EU as the first creditor (= *preventing any bail-out*); (ii) the concessional interest rate = EU bond rate + 50 basis points for creating an EU reserve fund (= *solidarity with a small fee*) (iii) the disbursement by tranches under approval by NECFIN in function of the strict respect of the committed budgetary measures in the Stability program (conditionality);

(iv) the transformation of the gains reaped by Greece from the difference between the high yields on its normal bonds and the concessional EU loan (something like 350 basis points) into a “virtual debt” of Greek citizens to the EU partners (= *strengthened conditionality by pre-decided automatic sanctions*); this potential debt would become automatically effective with a subordination clause in case of no-respect of the agreed consolidation path under the Stability program; (v) the assessment of the non-respect of the program would be made on technical basis by (autonomous) NECFIN (= *to prevent to be judge and part as before*). These tough conditions are necessary for ensuring the full respect of the no-bailing-out clause while being a powerful deterrent to any domestic political slippage or populist attempt that could impede the implementation of the committed adjustment. Any politician or trade unionist would know in advance the cost of a failure to adjust and this cost would grow exponentially with time, making progressively more credible the government announcements and measures, making possible an expectation driven recovery. The communication of the virtual debt would make visible the EU solidarity effect and could serve of an indicator of the Greek recovery of its financial credibility.

***... warranting both solidarity against excessive market reactions and market sanctions for respecting fully the technical conditions of sustainability...***

This structured plan would create both a visible EU solidarity action by reducing the unnecessary part of the financial costs for Greece, and a credible internalization of the spillover threatening the € area. Indeed, it answers both the financial markets, the worries of the “German taxpayers” and of the Greek citizens, by introducing a deterrent sanction together with an appealing incentive to adjust as needed, making guilty immediately any politician or trade unionists from sheltered sectors who would oppose to paying their own part in the collective bill the Greek population has to support for the sins of the past.

***...not just for Greece but as a systemic improvement of EMU...***

This emergency plan for Greece simultaneously would then open the way for other painful cases, preventing an overshooting of the financial markets and a worsening of the € crisis.

***...opening the way to innovative management of the €-bond markets with the progressive creation of an “€-debt-pooling-agency”...***

In addition, this plan opens a historical opportunity to test the political feasibility of a progressive transformation of the EU bond issues into a tool for unifying the €-bond markets through a future “€-debt-pooling agency” (EDPA)

Once demonstrated the advantages and effectiveness of enhancing the financial-market discipline through the subordination clause (and the labeling resulting from a technical sustainability exercise), it would become easier to negotiate the creation of the option of single €-bond market for new debts respecting the SGP, leading to the progressive unification of a significant share of the Member States past debts. The main advantages would be to create a genuine benchmark for the €-bonds and to extend the liquidity advantages to those qualified small Member States

(disappearance of liquidity spreads) while strengthening the financial-market discipline and opening new opportunities for a self-motivated coordination of fiscal policies even when the sustainability is not at risk.

The proposal would be the following: the EU would start issuing new bonds for buying certificates issued by Member States respecting the SGP, and benefitting from a subordination clause favoring the EDPA creditor. The difference of yields should be insignificant for Germany but positive for all the others. For these other Member States, the difference would be conditionally reduced to a thinner technical margin as far as their national budgetary policy remain fully on track with the SGP and the recommended reduction path in their debt ratio. These conditions would depend upon the technical surveillance and assessment done permanently by NECFIN reports in open debates with the markets. Once some divergences would occur the EDPA would charge a positive spread for generating incentives for adjusting the corresponding national budgetary policy, creating income for the EDPA reserves. Member States remain always free to go directly to the market if they consider possible to get better spreads on their own. The EDPA incomes (fix small margin plus spreads) would progressively feed a guarantee reserve for improving the €-bond rating in the future.

***...which could unified progressively the €-bond market while respecting the no-bailing clause and increasing the enforcement power of the SGP and the self-interest to coordinate budgetary stances.***

After experiencing this system, the EDPA would start to apply progressively the same system to part of the existing stock of debts, issuing its €-bonds (warranted by the EU) for swapping them against national bonds of these Member States meeting the SGP criteria and getting the green light from NECFIN. This swap transaction would involve a compulsory adhesion to a statutory subordination clause in favor to the EDPA (or the EU) for warranting the respect of the no-bailing-out clause. Nevertheless, the EDPA would continue to cover a part of the existing spreads (if there is one) at the moment of the transaction according to the market respective ratings. The generated income would feed the guarantee reserve for the EDPA.

The interest of this amplified swap system results from the combination of the following elements:

- 1) To increase the size of the unified €-bond market and its liquidity, redistributing part of this gain to the Member States, making attractive the adhesion to the swap scheme,
- 2) To warrant a reversibility option for both sides in case of strong disagreement on budgetary stance between the contracting parts
- 3) To provide a new instrument for enhancing market discipline on a permanent basis: any deficit in excess of the Maastricht criteria or on a divergent path with respect to the committed Stability programs would have to be financed by Member States alone, creating an additional spread which would also be automatically charged to the existing bonds already held by the EDPA. This mechanism would increase the enforcement power of the SGP and generate EU reserves.