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# EMU under pressure

Macroeconomic challenges and institutional answers



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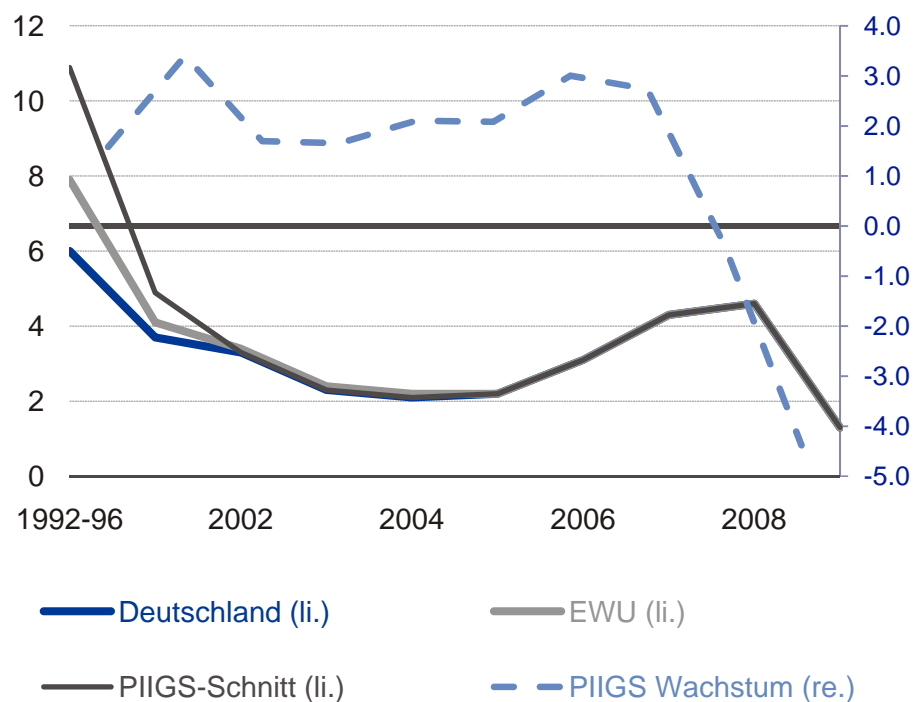


- 1** **Public debt as a challenge for EMU**
- 2** **Solution 1: European Monetary Fund**
- 3** **Solution 2: Debt brake for EMU countries**
- 4** **Conclusion**

# Different macroeconomic developments...

## Rocket Fuel for PIIGS

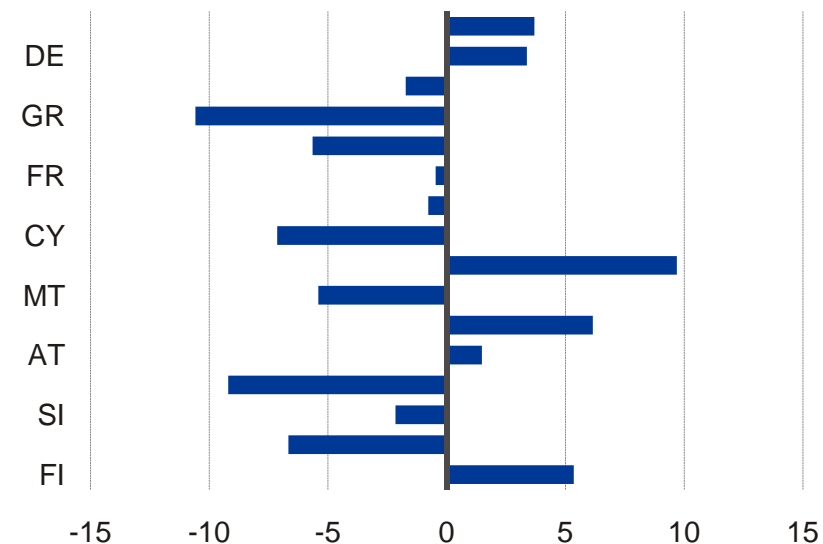
Short-term interest rates, 1992-2009



Source: Eurostat

## EMU: Long tradition of tensions

Current account balances, avg. for 1999-2009  
(% of GDP)



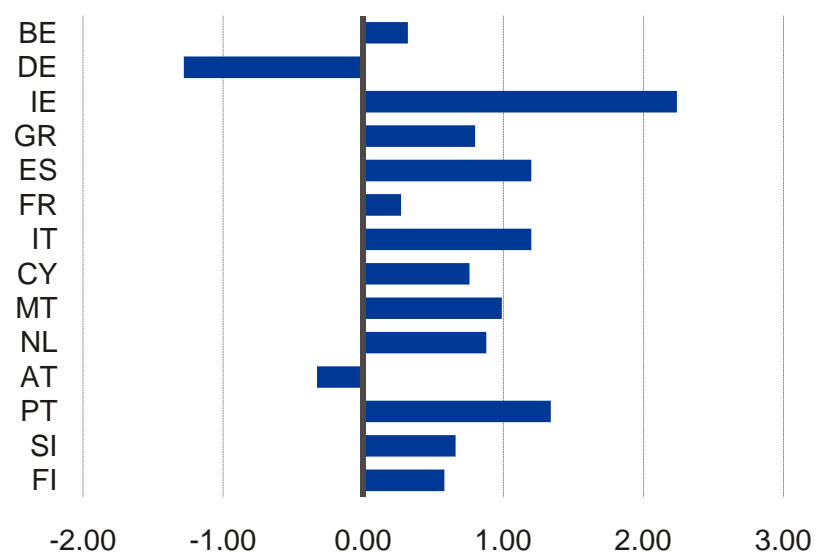
Source: European Commission



## ... have widened gaps in competitiveness.

### Varying price competitiveness

Real eff. exchange rate, annual average (%)  
1999-2009



Excl. Luxembourg and Slovakia Source: European Commission

### ■ Credit-based growth

- Low interest rates, high capital inflows, generous wage agreements (above productivity)
- Crisis triggers burst of speculative bubbles → slump in economic growth and high deficits
  - IE, GR, ES, PT

### ■ Consumption-driven growth

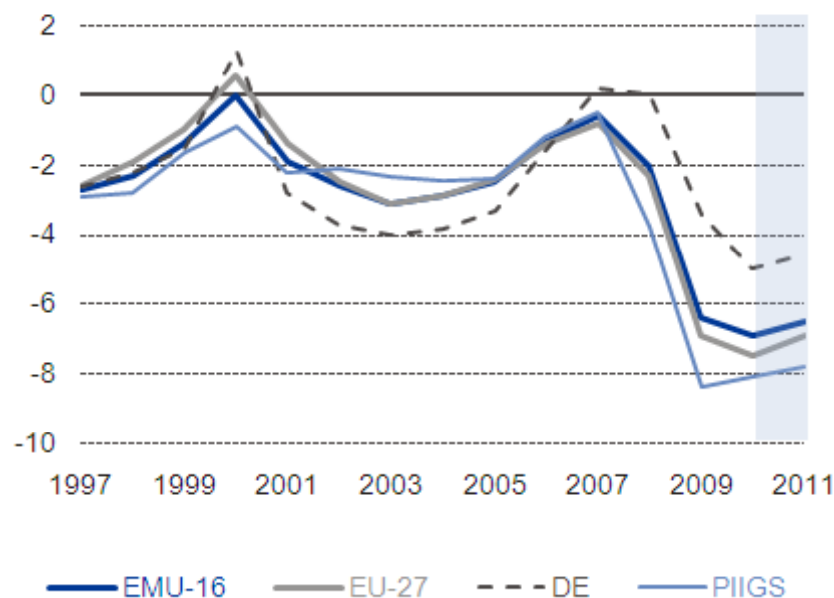
- Generous wage agreements limit competitiveness but strengthen domestic consumption
- FR, IT

### ■ Export-driven growth

- High level competitiveness supports growth
- However: Weak domestic demand
- DE, NL, AT

## Public deficits increased ...

### Public Deficits (% GDP)

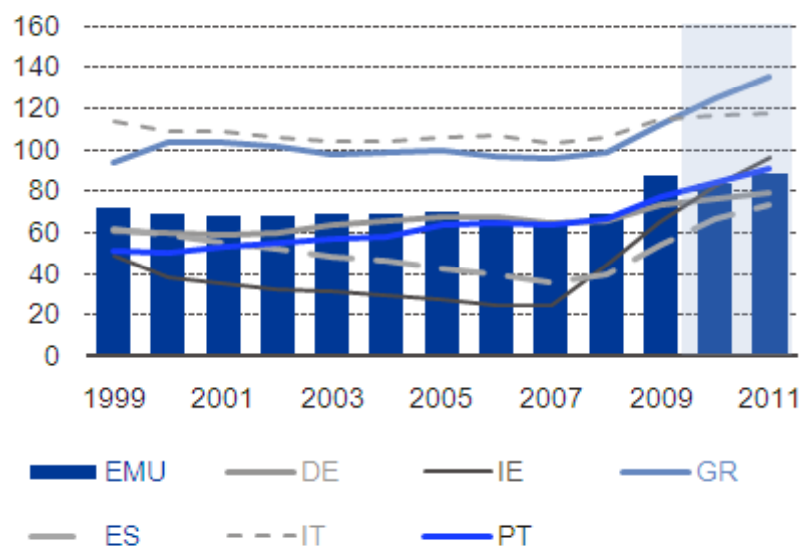


Source: European Commission

- Declining revenues of all EMU countries due to economic slump
- Increased spending: Automatic stabilisers, economic stimulus packages
  - EU-stimulus package in 2009/10: EUR 200 bn, 1.8% GDP), three times *Marshall Aid*
- Mixed results
  - Support of demand has prevented economies from slipping into a recessionary spiral.
  - Ratchet effects: Subsidies contrary to intended way back to growth
- Cyclical deficits increase due to economic contraction and increased output gaps

## ... the level of public debt and ...

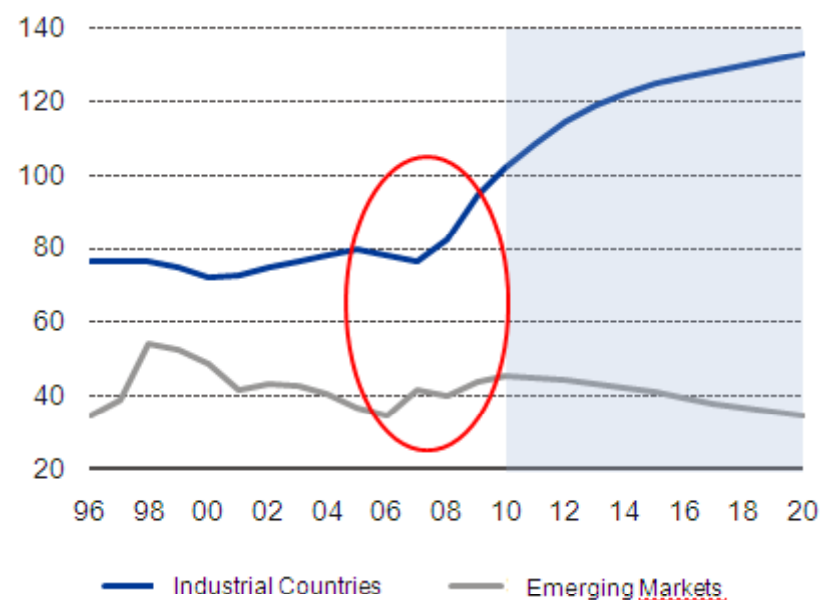
### Public Debt Levels (% GDP)



Source: European Commission

### Global Public Debt: Welcome to a new world!

Public debt, (% GDP)

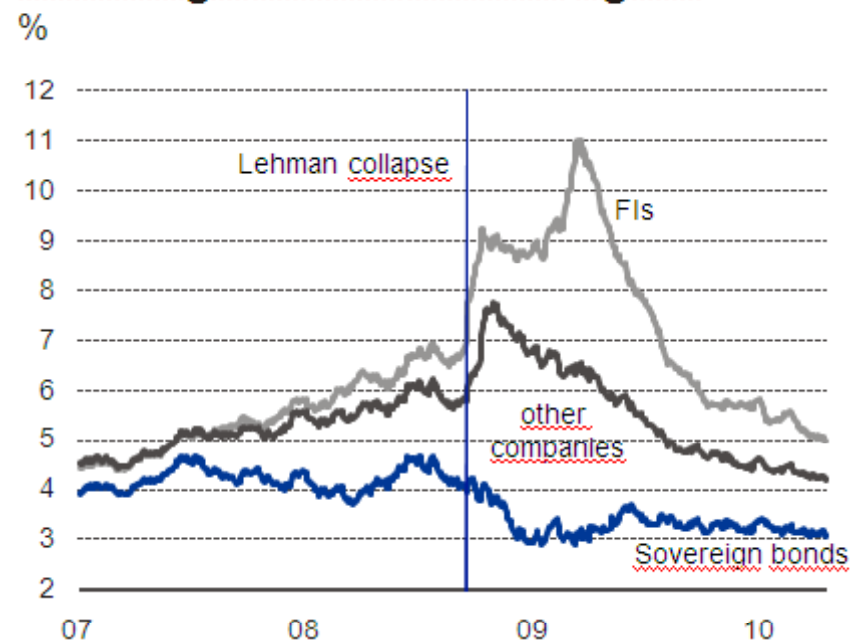


\*Source: DB Research, GDP-weighted average



## ... the risk of crowding out private investors.

### EMU: Spreads of corporate and sovereign bonds narrow again



Source: [iBoxx](#)

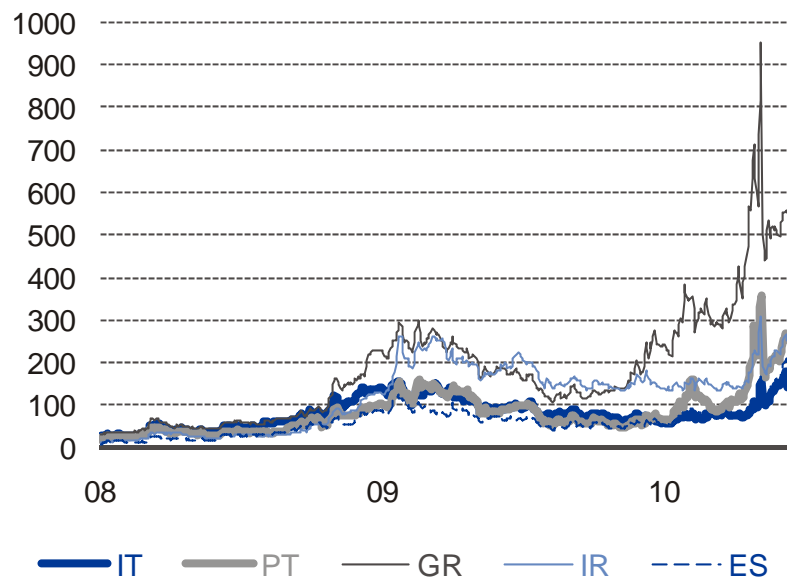
- High public deficits caused voluminous issues of sovereign bonds
- Companies had to increase their bond yields
- The refinancing situation of companies has relaxed (narrowing spreads between sovereign and corporate bonds)
- Nevertheless, the refinancing need of governments remains high



# Bond Markets: From soberness right to panic!

## Spreads over Bunds

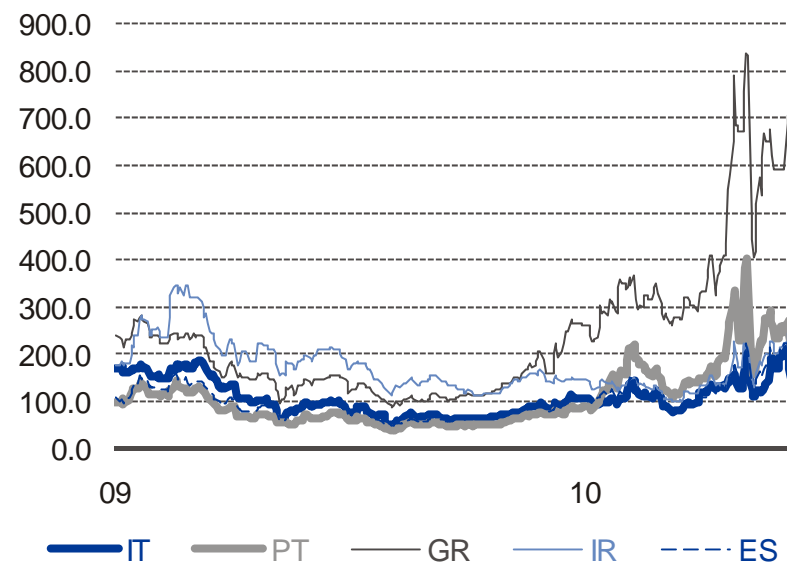
Basispoints10y



Source: Datastream

## CDS-Spreads: 10 year

Basispoints



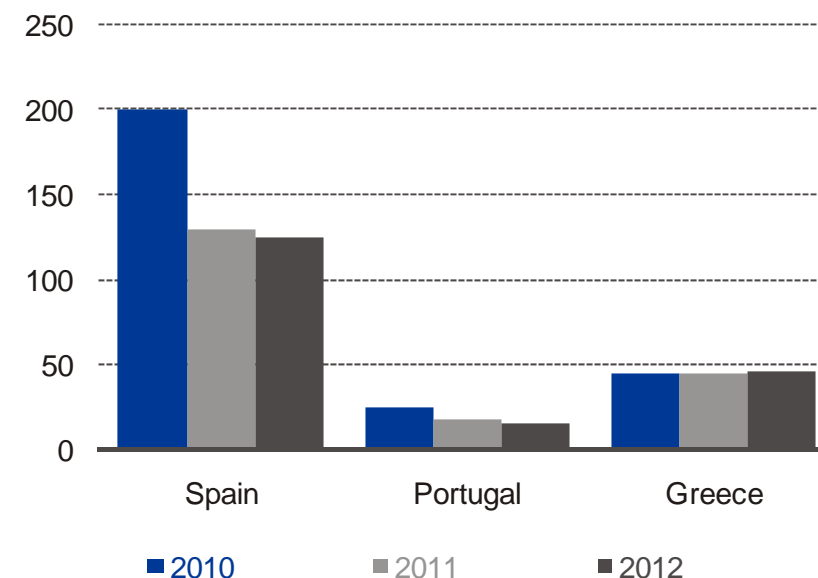
Source: Thomson / Reuters

## Measures: European Stabilisation Mechanism

- EU/IMF financing package for Greece  
EUR 110 bn over 3 years
- EUR 60 bn BoP facility  
run by the Commission; no member  
state approval required
- EU Financial Stabilisation Fund  
(EFSF)
  - EUR 440 bn
  - 120% guarantee of each Member State  
pro rata for each bond -> AAA
  - EFSF loans need approval of all EMU  
members
- IMF commitment of up to EUR 250 bn
- Measures exceed the 2010-12  
financing needs of ES, PT and GR!

### Financing needs: Estimates

EUR, bn



Sources: Bloomberg, Deutsche Bank



## Measures: Reforms of the Stability & Growth Pact

- Since de-facto control of the Greek budget, deficit procedure is (finally!) taken serious. Nevertheless: Current deficit procedure comprises 7 steps, sanctions biting too late.
- At the June summit EU agreed on:
  1. A more prominent role for public debt levels
  2. Sanctions within the preventive arm of the SGP
  3. Budgetary ex ante surveillance, earlier coordination of national budgets
  4. Stricter macroeconomic surveillance, e.g. via an economic scoreboard on competitiveness.
- But: No suspension of voting rights for deficit offenders, no automatic sanctions (although this might be taken up later in the year).
- In October van Rompuy's Task Force is to present its final recommendations for economic governance. New framework to include a sustainable crisis mechanism with a blueprint for a sovereign default in the EMU should be in place for 2011.
- Anyway, market's surveillance should work in the future!



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## The anatomy of the EMF

- Contribution parameters:
  - 1% annually of the stock of excess debt, i.e. difference between the actual level of public debt at the end of the previous year and the Maastricht limit of 60% of GDP
  - 1% of the excessive deficit, i.e. the amount of the deficit for a given year that exceeds the Maastricht limit of 3% of GDP
- Contributions would be invested in investment-grade government debt of euro area member countries
- Possibilities of EMF's financial support:
  - sell parts of its holdings (or raise funds in the markets) and provide the member country with a loan
  - provide a guarantee (funding) for a specific issuance of public debt
- EMF capable of organising an orderly default as a measure of last resort
- In case funds have to be raised in the market, debt service is paid from contributions

## The anatomy of the EMF

### ■ Stage I:

- Any member country is eligible to call on the funds of the EMF up to the amount it has deposited (including interest)
- Fiscal adjustment programme must be approved by the Euro Group

### ■ Stage II

- Larger drawing on the funding of the EMF only possible if the country in question agrees to a fiscal adjustment programme supervised by the Commission and the Euro group

### ■ Sanctions in case of non-compliance with the commitments:

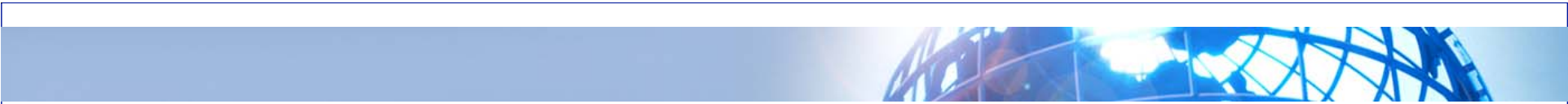
- Cut off new funding (guarantees)
- Cut off transfer payments under the European structural funds
- Cut off from the euro area's money market when the country's government debt is no longer eligible as collateral for the ECB's repo operations

## Orderly default procedure as a last resort

- EMF manages an orderly default of an EMU country that fails to comply with the conditions of the adjustment programme
- EMF declares to invest an amount equal to 60% of the GDP of the defaulting country (debt-to-GDP ratio)
- EMF acquires all claims against the defaulting country
- EU transfer payments under strict scrutiny of EMF
- Obligations resulting from derivative transactions not eligible for exchange



- EMF as a new framework for dealing with the possibility of a failure of one of EU member countries
- Advantages of EMF:
  - key mechanism to limit the disruption resulting from a default
  - clear incentive for partner countries to keep their fiscal house in order at all times (transparency of public finance)
  - best way to protect the interests of (relatively) fiscally strong member countries
- Criticism
  - A defaulting country may regard EMF's intrusion into its policies as a violation of its sovereignty
  - The European Commission could face political constraints in devising adjustment programmes
  - Political and fiscal cooperation may be opposed by member countries due to increased power of EU institutions



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## A Debt Brake for EMU countries?

### ■ The Stability and Growth Pact has been

- a success in building expectations
- no success regarding fiscal results
- no success regarding reactions on capital markets

### ■ EMU: Wide range of national fiscal rules

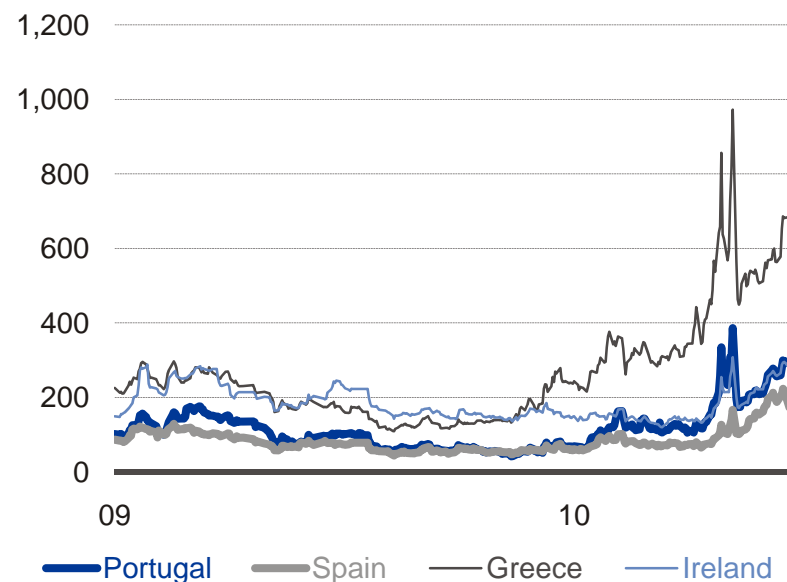
- Numerical deficit rules
- Debt rules
- Spending rules
- Cyclically adjusted deficit rules?

### ■ Need to complement gap between existing fiscal rules and the SGP

- Paradigm: German debt brake

### Markets isolate budget offenders

Spreads versus Bunds (10Y)



Source: Bloomberg



## The anatomy of the German debt brake

- Structural deficit component:
  - Limiting the structural deficit to 0.35% (GDP) of the federal government from 2016 onwards. No deficits on *Länder* level
  - Orientation on the SGP's MTO
  - Exceptions in case of natural disasters and special economic situations
- Cyclical component
  - *output gap x budget elasticity* [for 2006:  $1.20 \times 0.51 = 0.61$ ]
- Correction for financial transactions
  - e.g. revenues from privatisation cannot be used to fill the deficit gap
- Check account
  - Connects budget preparation and execution: If a higher deficit becomes necessary due to changes in the projected tax revenues, the check account controls for a correct budget execution. Refinancing by reducing the structural deficit of future years.
- Early-warning system: Surveillance mechanism by a stability council
  - No effective sanction mechanism against *Länder* violating the zero deficit rule.



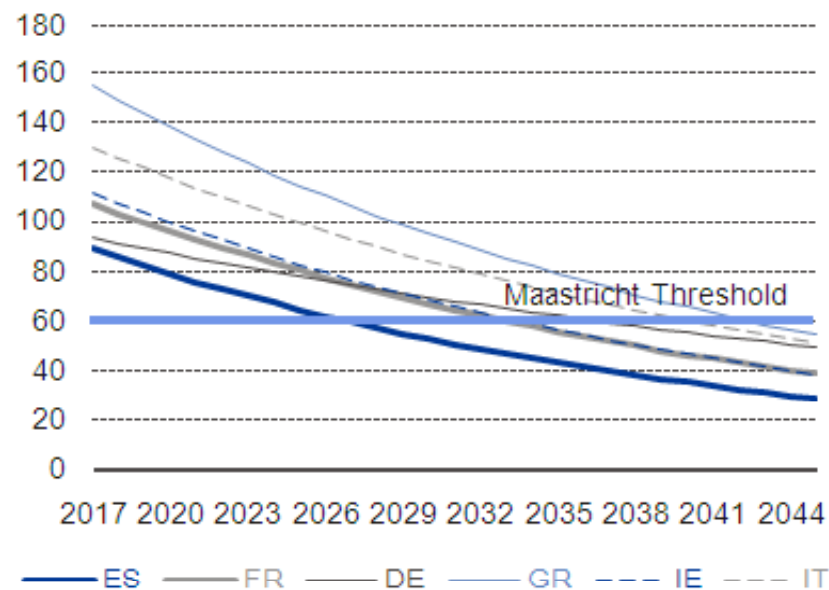
## The anatomy of the German Debt Brake

- Growth constraint as public consumption crowds out public investment?
  - Limitation in absolute terms prevents government from redefining budget items.
  - Higher investment among economic agents today in expectation of lower taxes in the future
- Is the latitude provided by automatic stabilisers too narrow?
  - Exceptions in case of special economic situations
- Asymmetric economic cycles could cause procyclical budgetary policy
  - Check account
- No incentives for structural reforms, such as provided by MTOs.

# Implementation in EMU

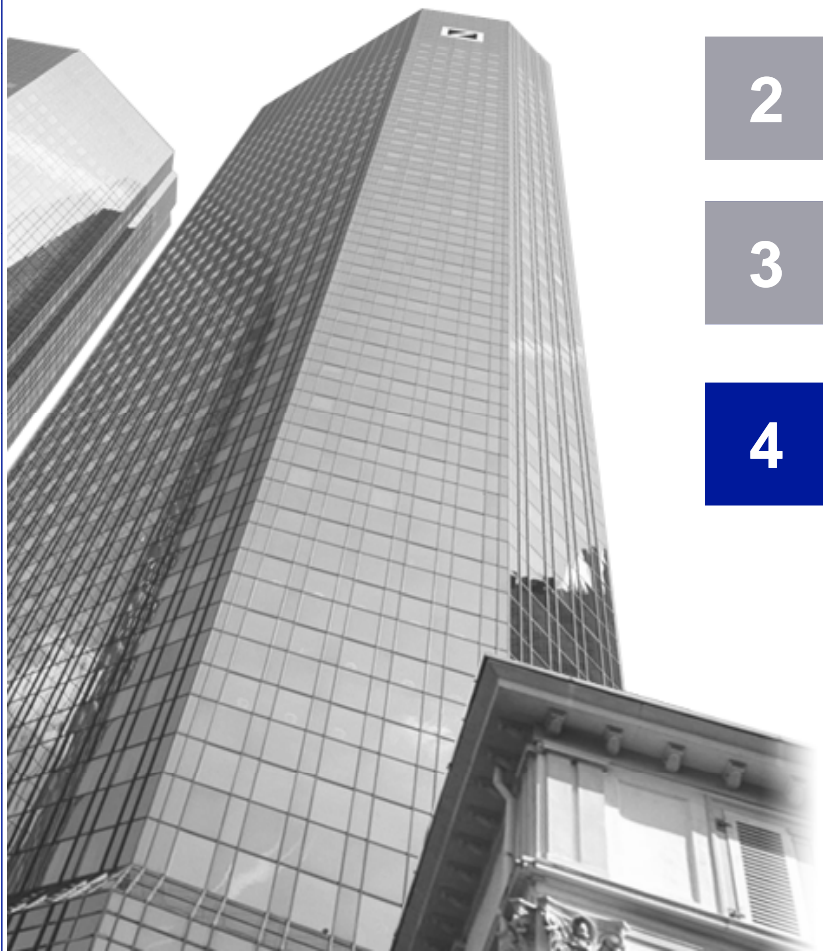
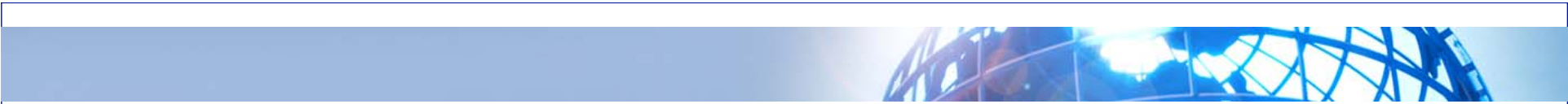
## Convergence of Debt Levels

Establishing the debt brake in EMU in 2016



Source: DB Research. European Commission

- Implementation in EMU would anchor the preventive arm of the SGP on national level
- Implementation
  - Voluntarily implementation: OMC
  - Mandatory implementation
    - Art. 136 TFEU
    - Change in Treaty
  - Mandatory implementation for countries under excessive deficit procedure



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## Conclusion: EMU at (fiscal) crossroads?

- Greece as an early warning to closer coordinate fiscal policies
- Reduction of public debt levels necessary regarding its implications for short term and long term growth
- The SGP is not a toothless tiger but a tool of fiscal coordination with a delayed effect; markets do not recognise its strength
- Proposal for short-term stabilisation: European Monetary Fund
- Proposal for long-term consolidation: *Debt brake* on a European scale



# Many thanks for your kind attention! Any questions?

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