GERMAN COUNCIL
of Economic Experts

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A European Redemption Pact

The EZ crisis has taken a turn for the worse. This column, the joint work of the five members of the 'German Council of Economic Experts', proposes a novel solution to the crisis – the European Redemption Pact and an associated European Redemption Fund. This would – like Eurobonds – create a joint debt vehicle, but unlike Eurobonds it would be temporary, say 25 years. Its aim would be to ease down the current unsustainable levels while implementing credible fiscal policy reforms in all EZ nations.

In the quest for a solution to the escalating European debt crisis, two equally important yet conflicting principles have led their respective proponents into an impasse that is continuously feeding this escalation, up to the point where a complete breakup of the Eurozone has become a serious threat.

- The principle of **accountability** demands that member countries engage into an irrevocable consolidation of their public finances and, eventually, into a reduction of public debt back into the realm of universally acknowledged fiscal sustainability.
- The principle of **solidarity**, on the other hand, requires the stronger member countries to support the weaker ones in times of severe crisis, thereby weakening the incentives among the recipients of any aid to display sufficient fiscal discipline once the climax of the crisis has passed.

The respective positions appear almost impossible to reconcile. Proponents of solidarity are stunned that their Eurozone peers let them stand in the rain even at the risk of their own peril, while proponents of accountability maintain that they have been disappointed by empty promises once too often.

In order to de-escalate the situation a mechanism is needed that allows for combining these two principles.

- It should be able to calm markets by demonstrating convincingly that solidarity will prevail. This can only be reached by strong countries lending their reputation, *ie* their low risk premia in the bonds market, to member countries facing a liquidity crisis.

At the same time a credible commitment is required to ascertain accountability, with all member countries adhering to the European Stability and Growth Pact at least in the long run. It would then be possible to discuss suitable avenues to design the future governance structure of the Eurozone in calmer weather, without the gun-to-the-head urgency of the current situation.

A proposal: The European Redemption Pact

In the annual report released on 9 November 2011, the German Council of Economic Experts has put up for discussion the idea that European leaders consider one such potential mechanism, a **European Redemption Pact**. Resting on provisions made by the revised Growth and Stability Pact, this would combine joint and several liability and strong individual commitment in refinancing the Eurozone members over the next couple of years and, simultaneously, provide a road map to each member country reaching a 60% debt-to-GDP ratio within another two decades, after which the ERP would be set to expire.

As always, the devil is in the detail, and the proponents of accountability will have to fence adamantly for their principle being reflected sufficiently in the concrete design of the European Redemption Pact.

The key idea of the our proposal is the separation of the debt that has been accumulated to date by individual member countries of the Eurozone, into a part that is compatible with the 60% debt threshold of the SGP, and a part exceeding this threshold.

Following the sequence of immediate refinancing needs in a roll-in phase stretching over the next couple of years, participants in the Redemption Pact shall be able to refinance themselves through a joint **European Redemption Fund**, until the amount of debt refinanced through the ERF reaches the current difference between the debt accumulated to date and the hypothetical debt that would just equal 60% of GDP, *ie* the SGP debt threshold.

While each country will henceforth have to service its own debt financed via the new Fund until it is completely redeemed and the new Fund expires, participants will be jointly liable for the debt, thus ascertaining affordable refinancing cost for all participants.

Not Eurobonds

The decisive difference from the idea of Eurobonds, in addition to its limited duration, lies in the strings attached to the participation. Specifically, a serious commitment is required to safeguard that the debt not refinanced via the mechanism does not rise above the 60% debt-to-GDP threshold again. This needs to be guaranteed by **debt brakes** being introduced in the participants' national constitutions.

- The cases of Germany or Switzerland could serve as examples for the design of such a constitutional rule.
- The proposed construction would allow for these changes at the constitutional level to take some time, as the roll-in into the ERF is stretched over a range of several years.

If a participant failed to honour this commitment during the roll-in phase, the roll-in would be stopped for this country. In addition, the redemption of the debt would be ascertained by **special tax provisions** which are designed to generate revenue earmarked for servicing the debt. Finally, each country has to guarantee its debt in the Fund by a 20% deposit in the form of international reserves (gold and foreign exchange reserves). Whenever a Redemption Pact participant failed to honour its

commitments, the participant would forfeit the **collateral** deposited with the new Fund.

At the end of the roll-in phase the size of the new Fund would be approximately €2.3 trillion, if all members of the Eurozone participated which are currently not supported by the European Financial Stability Fund (EFSF). The two most important participants would be Italy with slightly more than 40% and Germany with approximately 25%. As time proceeds, the debt accumulated in the new Fund would be redeemed until the Fund is dissolved, which would happen in about 25 years. This **redemption path** will require tremendous efforts from the participant countries, and the task will be harder for the countries starting the process with a higher debt ratio.

The required primary surplus for Italy to achieve this objective would be 4.2% of GDP for each year in the redemption period, assuming that nominal GDP grows at 3% per annum, the new Fund were to confront refinancing cost of 4% and the interest rate Italy has to pay is 5% for the remaining debt. Achieving a primary surplus of 4.2% of GDP over a prolonged period of time will require sustained fiscal discipline. However, the scheme should still be **attractive** to Italy **despite the strict conditions** attached to participation, since the joint and several liability of the Fund ensures lower refinancing cost. The primary surplus required for Italy to achieve the same reduction in debt without the ERF scheme (assuming an interest rate of 7%) would initially be more than 8% of GDP.

For the ERF's second-most important contributor, Germany, participating would reverse this advantage into a disadvantage, though Germany will only be convinced that participation in the new Fund is worthwhile if

- The **alternative** would indeed be the worst-case scenario of unlimited refinancing of Eurozone members through the European Central Bank; and

- If the provisions to ascertain fiscal discipline and the limited European Redemption Fund lifeline can be made **credible**.

The highest constitutional safeguards, in the case of Germany a referendum, will have to be put in place to ensure that the ERF does not degenerate into unconditional Eurobonds.

Certainly, the European Redemption Pact is a grand scheme which requires bold action and a long term commitment to the Eurozone. In return, it offers the promise of a definitive solution to the crisis by redeeming debt rather than piling on new debt.

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