cep**Study**

A sovereign default regime for the euro area

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Executive Summary

The issues

- There are three causes behind the euro crisis: excessive government deficits, different levels of competitiveness in various eurozone countries and the bursting of a credit bubble, after which already faltering states tried to save systemically important financial institutions from default.
- The measures taken to prevent future crises – in particular the reforms to the Stability and Growth Pact and the country-specific recommendations, the introduction of macroeconomic surveillance and the Fiscal Compact – cannot prevent future crises.
- This is because they ignore a fundamental issue, which is irreparable for the foreseeable future: there is a lack of willingness in all eurozone countries to consistently adjust national fiscal, economic, labour market and social policies to these measures. The European requirements for economic reform and consolidation are being ignored in many countries.
- This deficiency ultimately stems from two causes: Firstly, the eurozone countries have not reached a consensus, but openly disagree on what role the market should play as a mechanism for ensuring discipline and coordination. Consequently, the reform requirements are in many cases completely contrary to the economic culture and traditions of the affected country. Secondly, citizens and national politicians feel patronised by requirements set by Brussels and other EU States.
- Debt mutualisation and lasting transfer payments between EU States would be liable to encounter partial forceful resistance in the populations of those countries that would be the potential net contributors.

Requirements for a solution

- A solution to the eurozone's problems, and its survival, requires that all eurozone countries be once again allowed to make their own decisions regarding timing, type and scope of reforms. This is the only way to ensure that their economic culture and tradition are taken into account and that they do not feel as though they are under external control. However, it must not be possible for fiscal or economic difficulties in one eurozone country to trigger crises in other eurozone countries.
- Allowances can be made for the above problems by introducing a sovereign default regime for the eurozone countries.
- The sovereign default regime must fulfil the following requirements:
  (1) The enforcement of sovereign default must be credible.
  (2) In the case of a sovereign default, national and international investors and the national voters in their capacity as taxpayers are exclusively liable, and not the taxpayers of other countries.
  (3) Every country must be able to control its own fiscal, economic, labour market and social policies.
  (4) Any developments that threaten the solvency of a country must become obvious at an early stage so that investors and voter have a chance to respond,
  (5) Imbalances in the financial sector must not, in general, threaten sovereign solvency,
  (6) Financial institutions must be able to cope with the sovereign default.

The elements of a sovereign default regime for the eurozone countries

- **The key element: Early, automatic haircut.** If the debt level of a eurozone country reaches 90% of GDP (reference value), a haircut of 10% will be triggered automatically. Controlled default with a small haircut will be enforced early on instead of uncontrolled default. This has the following advantages:
  (1) Investors can form clear expectations about their risk of loss. Abrupt increases in spreads will give way to a successive rise in spreads if the state in question approaches the reference value. "Panic sales" and "contagion" in other eurozone countries are avoided.
  (2) Gradually increasing spreads lead to a slow but constant increase in the pressure for reform. This gives the government time to make corrections. As a result, national politicians are neither misguided by the illusory assurance that reforms are not yet necessary, nor are they suddenly confronted with doubts about their country's debt sustainability obliging them to take hasty countermeasures that in turn precipitate an economic downturn and cause the further erosion of debt sustainability.
  (3) If a state approaches the reference value, credit financing becomes more expensive for businesses and consumers, too. They will thus have sufficient time and opportunity, at the latest when it comes to the next election, to inform their politicians of their preferences.
  (4) Existing incentives to delay default as long as possible, thereby raising the default costs, are eliminated.
- **Transitional arrangements for eurozone countries whose debt level amounted to more than 75% of GDP in 2014.** The haircut must be performed where the debt level exceeds the 2014 level by 15 percentage points. This transitional reference value is reduced by one percentage point in each subsequent year, until it reaches the reference value of 90%.
- **Accompanying measures to prevent new debt via the ECB's TARGET system.** A steady reduction of TARGET imbalances would be advisable. The minimum requirement should be that TARGET claims and liabilities may not increase any further. To achieve this, newly arising account balances would have to be settled once a year by transferring tradeable securities.
- **Accompanying measures to (partially) shield governments from the default of financial institutions.** The provisions passed by the EU are appropriate: The bank resolution costs will now be covered, in the first instance, by owners, creditors, depositors of sums over € 100,000 and the EU banks; secondarily by the affected countries; and in an emergency the ESM can grant the country a loan or recapitalise the banks directly. In addition, the ESM should be able to grant a loan to the European Bank Resolution Fund for the recapitalisation of the affected banks.
- **Accompanying measures to shield financial institutions from sovereign defaults.** Government bonds must be covered with equity capital, otherwise the consequences of a sovereign haircut are too drastic and the haircut itself loses its credibility. An upper limit for the volume of government bonds held by a financial institution should be introduced.
- **Consequences for the existing precautions to safeguard the solvency of eurozone countries.**
  (1) The Stability and Growth Pact is superfluous and can be abolished.
  (2) Apart from direct bank recapitalisation, the European Stability Mechanism (ESM) will otherwise only grant loans to countries or to the Bank Resolution Fund for the recapitalisation of banks. The traditional loans to countries, generally used until now to prevent sovereign default, will no longer be possible.

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1 Introduction

The eurozone is at a crossroads. Originally conceived as a monetary union in which each member assumes sole responsibility for its own fiscal soundness, it has been experiencing fundamental changes since March 2010. The imminent default of Greece, shortly followed by that of Ireland and Portugal, as well as highly problematic developments in other southern European countries have led to the abandonment of the no-bailout rule and to unprecedented financial assistance and guarantee commitments being provided by one eurozone country to another. In return, the countries requiring support pledged to implement concrete reforms to improve competitiveness; consolidate their national budgets and restructure their financial sectors. As a result, numerous measures have been agreed and provisions adopted that aim to ensure that such crises never arise again. They apply to all eurozone countries and their approach is to increase coordination of economic policy and ensure stricter monitoring of national budgets.

These rules have been accompanied by demands for the monetary union to undergo long overdue development and form a political or fiscal union. The question that hasn't been answered yet is what form such a union should take. Suggestions range from a EU economic government, which would be responsible for minimum wages, pension policies, harmonised taxes and product markets as well as promoting coordinated structural reforms[1], to rights granted to the EU Commission to intervene in national budgets, joint deposit guarantee schemes, Eurobonds, EU-wide unemployment insurance and a fully-fledged European Parliament for countries belonging to the eurozone. At the beginning of June, the French and German finance ministers presented a joint concept for developing the monetary union.[2] The concept provides inter alia for the introduction of a default regime for eurozone countries - which is not further elaborated upon. The latest proposal on strengthening the Economic and Monetary Union was the Five Presidents' Report published on 22 June 2015. This called, inter alia, for the introduction of a "mechanism to cushion economic shocks"[3]. The aim of the mechanism will be to absorb severe economic shocks.

At the same time, however, encroachment on national sovereignty is being met with increasing resistance by the Member States. Thus Greece only partially implemented the troika's adjustment programme and has since completely broken off cooperation with the troika. The French government is not willing to bring the French budget into line with the requirements of the Stability and Growth Pact. Instead of imposing sanctions, the European Commission continually extends the adjustment period by interpreting the rules of the Pact as flexibly as possible. In Germany, meanwhile, demands made by the European Commission for disincentives for second earners to be abolished are consistently being ignored. A fiscal or political union would, however, see such interventions become the order of the day.

To date, the unwillingness among eurozone countries to implement the requirements and -recommendations for reform set by the EU has been met with even closer coordination and monitoring of economic policies and fiscal matters. However, this response will not result in the eurozone countries implementing European guidelines more rigorously in future. This applies to both southern and northern eurozone countries alike as no government likes to be dictated to.

Furthermore, the requirements and -recommendations for reform made by the EU are seen in many European countries unsuitable for their own economic policies. In those eurozone countries which are unaffected by them, on the other hand, they are frequently considered to be not strict

1 German government (2013).
2 Cf. Gabriel/Marcon (2015).
3 Cf. Juncker et al. (2015), p. 6.

enough. Against this background, the introduction of a political or fiscal union is not just politically unrealistic but also counter-productive.

The problems do not stop there: With the existing European Treaties imposing strict limits on future coordination measures, a fundamental and time-consuming revision of the Treaties would be unavoidable. Already a partial renunciation of budgetary autonomy touches at the core of the sovereign states. This results in complex questions surrounding constitutional law and clashes with the constitutions of various Member States are only a matter of time.

It is already clear that policymakers are heading down the wrong track in their efforts to stabilise the eurozone. Instead of imposing greater levels of coordination and monitoring, the eurozone countries should be granted as much freedom as possible. This, however, requires that the actions of individual eurozone countries only have very few, if any, effects on their counterparts. Political debates repeatedly recognise that a resilient approach for dealing with insolvent countries is required but regrettably this does not yet exist. Developing such a sovereign default regime forms the focus of this study.

Chapter 2 briefly outlines the causes of the crisis and details the current political measures being taken to alleviate its effects and prevent future crises. Chapter 3 focuses on the underlying fundamental meta-economic problems of the eurozone, while Chapter 4 establishes a sovereign default regime.[4] Finally, chapter five will describe the main changes that are necessary for the legal transposition of the measures.

[4] This paper develops the suggestions made by authors of the study "A sustainable system for the euro" ("Eine nachhaltige Ordnung für den Euro") commissioned in June 2013 by the Initiative Neue Soziale Marktwirtschaft.

2 Taking stock of how the crisis has been handled

This chapter summarises the causes of the current crisis (2.1), examines the measures taken at a European level to alleviate the immediate crisis (2.2) and prevent future crises (2.3).

2.1 Causes of the euro crisis

At the height of the crises, five of the then seventeen eurozone countries, namely Greece, Ireland, Portugal, Spain and Cyprus, were reliant on financial assistance from the European bailout funds. As of June 2015, only Greece and Cyprus, out of the now 19 eurozone countries, are still in the ESM programs. In every case the capital market players doubted the sustainability of the public debts. The European Central Bank's announcement (which was never implemented) that it would purchase an unlimited number of bonds from struggling countries, in the event of an emergency ("OMT Program"), and the Public Sector Purchase Program initiated in March 2015 by the ECB, do nothing to change the actual situation within these countries nor to put an end to the doubts, but only succeed in increasing the expectation of outside assistance on the part of both national governments and capital market players.

While the reasons why these countries have found themselves in such a situation vary, the euro crisis can essentially be attributed to three causes, which apply to varying extents in each of the crisis states mentioned.

Excessive government deficits in numerous eurozone countries form the first reason. The Stability and Growth Pact that was meant to prevent this had no effect. Between joining the eurozone and the outbreak of the financial crisis, i.e. between 2001 and 2008, Greece had an average government deficit of 6.2% of GDP.[5] The Stability and Growth Pact permits a maximum deficit of 3%. Increasing government debt will inevitably result in doubts being expressed about the country's debt sustainability.

The second – and even more fundamental – cause of the crisis lies in the **varying degrees of competitiveness** in the different eurozone countries. A competitive economy is necessary because a country needs to raise taxes in order to service or repay its debts. If a country belonging to a monetary union experiences a drop in competitiveness, the economic power of this country is also reduced. In turn, the tax basis erodes and debt sustainability falls. Furthermore, a reduction in competitiveness also results in a slump in investment as well as capital flight and/or to current account deficits. The latter have to be financed by net inflows of capital. These loans from abroad can only be repaid once the national economy has generated the funds needed to do so, a process requiring current account surpluses. This requires current account surpluses. These divergent developments have also taken their toll on the debt sustainability of the countries mentioned and called it into question.

The third cause of the crisis is the bursting of the real estate bubble, subsequently followed by that of the **credit bubble**. This threw the financial sector into immense turmoil, pushing a number of financial institutions to the brink of insolvency. As the bankruptcy of large financial institutions in particular may bring about the collapse of the entire financial system (too big to fail issue), they were saved using government funds. Between October 2008 and October 2012, more than 90 financial institutions received financial aid from governments across the EU,[6] and the strain that

5 Source: Own calculations, Eurostat.
6 EU Commission (2012a), p. 28.

this put on public finances also caused the debt sustainability of the affected countries to be called into doubt.

2.2 Measures to ease the immediate crisis

Mutual financial support between the eurozone countries has become the most important means of abating the urgent problems. In this context, Greece was given bilateral loans in 2010. This was shortly followed by the creation of various additional **"rescue packages"**, into which the guarantees made between the eurozone countries were consolidated. From 2010, these initially included the European Financial Stability Facility (a total of 780 billion euros of funds guaranteed by eurozone countries), the European Financial Stabilisation Mechanism (68 billion euros of EU funds) and loan commitments from the International Monetary Fund (250 billion euros).

In exchange for this financial assistance, the affected countries were obliged to make reforms, the specific content of which had to be agreed with the "Institutions" (formerly "troika") consisting of the European Commission, European Central Bank (ECB) and International Monetary Fund (IMF), in detailed programmes.

In 2012, a **European Stability Mechanism** (ESM) superseded the first two financing instruments named above. Its subscribed capital amounts to 700 billion euros, comprising "paid-in capital" of 80 billion euros and "callable capital" of 620 billion euros.
Further assistance came in the form of the **rescue efforts of the European Central Bank** (ECB), which also tried to ease the immediate crisis. On the one hand, it used its monetary policy to do so. In particular, this involved the historically low prime rates; conducting its main refinancing operations with full allotment, which saw commercial banks being provided with unlimited liquid funds if they deposited the required securities; and reducing the rating requirements of asset-backed securities which had to be deposited by the commercial banks with the ECB during refinancing operations. On the other hand, it employed "unconventional" measures by making use of the following mechanisms: emergency liquidity assistance (ELA), a process in which national central banks support illiquid commercial banks; the Securities Markets Programme (SMP), which was used to purchase government bonds directly from the secondary market until 6 September 2012; the Outright Monetary Transactions Programme (OMT) announced by President of the ECB Mario Draghi on 6 September 2012, which the ECB can use to buy unlimited government bonds on the secondary market when required; and via the "Public Sector Purchase Programme" from which the ECB has acquired government bonds amounting to € 170 billion since March 2015.[7]

2.3 Measures to prevent future crises

In addition to the measures taken to ease the immediate crisis, agreements were made with the aim of preventing the emergence of future crises.

Firstly, both the corrective (ex-post evaluations) and preventive (ex-ante evaluations) arms of the **Stability and Growth Pact** were intensified.

In the corrective arm, the rules on sanctions were tightened especially, making it possible for them to be imposed earlier and with greater ease in the event of non-compliance with the pact. The conditions for imposing sanctions have been extended, meaning that they may not only be used

[7] Consolidated financial statement of the Eurosystem as at 12 June 2015, available at: https://www.ecb.europa.eu/press/pr/wfs/2015/html/fs150616.en.html; last retrieved on 23 June 2015).

when the government deficit has exceeded the 3% mark but also when the level of debt surpasses 60% of GDP and is not diminishing significantly. Voting rules making it easy for the Council to reject a Commission recommendation to impose sanctions have been tightened. Furthermore, the monitoring of eurozone countries that are subject to an excessive deficit procedure has been tightened.

The preventive arm was intensified by the fact that from now on eurozone countries must each year provide the Commission with plans for their national budgets for the following three years as well as drafts of their national budget laws. The Commission checks these drafts and, where necessary, may request that the budgetary planning is revised. Only then may national governments pass their budget laws.

Secondly, **macro-economic monitoring** has been introduced to recognise the waning international competitiveness of an EU Member State at an early stage and encourage the country in question to introduce corrective steps. Furthermore, it aims to identify risks arising from asset-price bubbles.

Thirdly, the Council must now provide justification as to why it considers **country-specific recommendations**, in which the Commission states which reforms are necessary in each individual country and what remedial action needs to be taken, to be inappropriate.

Fourthly, **by signing the Fiscal Compact**, all of the EU Member States apart from the Czech Republic and the United Kingdom have undertaken to tighten their national budgetary rules and, in particular, to include a balanced-budget amendment in their national legislation, preferably as a constitutional rule.

Fifthly, the **"Banking Union"** has been passed. In the eurozone, large banks will now be monitored by the European Central Bank ("Single Supervisory Mechanism", SSM)[8]. The "Single Resolution Mechanism" (SRM)[9] will facilitate the orderly liquidation of ailing banks in the eurozone. In order to ensure that the liquidation of banks does not cause refinancing problems for countries, a Bank Resolution Fund has been set up for the eurozone whose funds are gradually being mutualised.

8 Regulation (EU) No. 1024/2013
9 Regulation (EU) No. 806/2014

3 The fundamental meta-economic problem in the eurozone

The agreements reached to remedy the current crisis and to prevent any future crises contain a diverse range of weaknesses and inadequacies[10], which cannot and do not need to be discussed in greater detail here. However, the central tenets are: All of the instruments introduced to make Member States take steps towards budget consolidation and economic reforms have revealed a common, deep-seated problem which will remain irreparable for the foreseeable future: eurozone countries – in northern Europe just as in the south – are exhibiting a distinct lack of willingness to take positive action. This deficiency ultimately stems from two causes:

First of all, residents and politicians in the eurozone countries feel they are under external control. This feeling was and is particularly pronounced in "programme-countries", who have received financial assistance from other eurozone countries via "bailouts" only in return for rigid reform undertakings. In contrast those States that are financing the assistance – like any lender – are anxious to exert as much influence as possible over how the money is spent, in order to maximise the likelihood that the assistance can eventually be paid back.

However, this feeling of acting under orders is not just limited to those countries who have received financial assistance, but is apparent in others too, not least in view of European provisions to prevent future crises. This applies in particular to the reinforcement of the Stability and Growth Pact, which reduces the scope for national fiscal policies, and to the introduction of macro-economic monitoring, which reduces the scope for national economic, labour market and social policies. Eurozone countries have formally agreed to the new rules, although these were only a general, abstract framework. The task of building on and implementing these rules falls to the European Commission, which is able to independently initiate an excessive deficit procedure and make country-specific recommendations. When it does so, citizens and politicians in those countries soon feel that they are being patronised.

Secondly, and more seriously: the eurozone countries have not reached a consensus, but openly disagree on how future crises should be avoided. The ideas of 'appropriate' fiscal, economic, labour market and social policies are too divergent to reach such consensus. Consequently, the Commission's recommendations for reforms and its budgetary recommendations are in many cases completely contrary to the economic culture and traditions of the affected country. At times, they demand radical re-thinking and fundamental changes in behaviour. Germany, for example, is not prepared to stimulate domestic demand by increasing wages to reduce its current account surplus.[11] In other eurozone countries, calls to reform the labour market and consolidate the budget are heavily criticised.

Both problems – the feeling of being patronised and the differences in economic cultures and traditions – were epitomised by the French president François Hollande's response to the Commission's country-specific recommendations for France, in May 2013: "The European Commission cannot dictate to us what we have to do".[12] In Italy too, the reform process pursued in

[10] For the weaknesses of the rescue packages, see the cepPolicyBriefs "European Stability Mechanism (ESM)" and "Reform of the European Financial Stability Facility (EFSF)". For the weaknesses of the reformed Stability and Growth Pact and macro-economic monitoring, see cepAnalysis "Is it possible to rescue the Euro by a reformed Stability and Growth Pact?" For the problems with the fiscal compact and the Euro Plus Pact, see cepPolicyBrief "Fiscal Correction Mechanism" or the cepStandPoint "Full speed ahead to the debt union".

[11] See also EU Commission (2012b), p. 6.

[12] Spiegel-Online (2013):Wirtschafts- und Finanzkrise: Hollande verbittet sich Diktat aus Brüssel, 29 May 2013, online at: http://www.spiegel.de/politik/ausland/krise-hollande-verbittet-sich-einmischung-aus-bruessel-a-902685.html.

2012 by the then Italian prime minister, Mario Monti, stalled and is now making, at best, sluggish progress. This problem becomes very clear when one considers Greece's attitude of refusal which has been in evidence since the change of government at the beginning of 2015.

Both problems – the feeling of being patronised and, to an even greater extent, the differences in economic cultures and traditions – create resistance to reforms in the eurozone countries. And there’s more: each problem just exacerbates the other.

As both problems mutually escalate, they play a more decisive role the slower the adjustment process becomes. Short-term reform programmes can be put in place by newly-elected governments with a clear parliamentary majority, before the general public can begin to organise entrenched protest movements. But the more protracted the reform process, the more politicians have to be mindful of the public’s stance, if only because they face elections on a regular basis. Even reform-minded politicians can and will not stand against the wishes of their electorate for more than a brief period.

The time element can hardly be overstated, since the fundamental structural reforms and budgetary consolidations which many eurozone countries are being called upon to carry out will run over a number of years and are inevitably going to be linked to deep cuts for the general public, which in turn leads to increasingly intense resistance. This means: The longer the reform process lasts, the harder it is to carry out.

By implication, this means that: long-lasting reforms can only be successfully carried out if, despite all the cuts, the general public as well as the politicians are prepared to support these measures. Even once national sovereign rights have been transferred to a supranational level – as in the EU – backing by the general public is still absolutely central to compliance with common rules, since the supranational institution may well have to assert these rules in the face of national resistance. European budget and deficit provisions, and the European Commission as custodian of these, have never enjoyed this backing.

To compensate for this lack of will among the general public and national governments to implement reforms and stability guidelines, the threat of sanctions was and is being used to try to force the measures to be put in place: crisis states that do not implement their adjustment programmes are threatened with the suspension of financial assistance. Countries that do not comply with the Stability and Growth Pact requirements must be aware that they will be liable for penalty payments. That this has not proved to be a successful way to implement the European guidelines. In fact, the Commission has shied away from clamping down. Instead, time limits for correcting excessive deficits have been consistently extended and concepts redefined.[13]

[13] As in the Communication COM(2015) 12 Making the best use of the flexibility within the existing rules of the Stability and Growth Pact.

4 A sovereign default regime for the eurozone

The eurozone will only survive in the long term if the wishes and preferences of the politicians and citizens of the Member States are considered, because ultimately it is impossible to implement a long-term political strategy for saving the euro that conflicts with their explicit political aims and ideals. Four such requirements must be taken into account:

- For the reasons outlined in chapter 3, the eurozone countries are not sufficiently willing to let themselves be patronised by the EU or other eurozone countries or be forced into implementing demands for fiscal consolidation and economic reform.
- At the same time, the citizens of many eurozone countries are neither inclined to permanently transfer sums of money to other eurozone countries nor mutualise the risks, regardless of whether this is carried out using Eurobonds or other means.
- The vast majority, if not all, of EU Member States are not willing to pass the political powers that are inherent to the very existence of a sovereign state to the EU, be they in terms of labour market, social or fiscal policies.
- The eurozone should remain configured as it is. All European and national players have made it clear that they do not wish for a country to leave the eurozone under any circumstances.

Realising these four political ideals is like trying to square the circle. It is nevertheless possible. The creation of a sovereign default regime for the eurozone countries is essential for achieving this aim.

This chapter will propose such a regime for the eurozone. Firstly, the required contents of a resilient default regime need to be deduced (4.1). The key elements of the regime (4.2) and the necessary accompanying regulations (4.3) will then be put forward. As it is not possible to introduce such a regime on an ad-hoc basis, a transitional arrangement will also be proposed, which would allow this regime to eventually be implemented. Finally, the extent to which the proposed sovereign default regime complies with its required contents will be examined (4.4).

4.1 Required contents

4.1.1 Trust in the validity of the law must be restored

All commercial activities are affected by an inherent uncertainty about what the future holds. Legal provisions may reduce the uncertainty by limiting the options available to those participating in these activities in the event of certain circumstances arising.[14] This stabilises the expectations of all players and increases their willingness to develop long-term plans,[15] including the building up of savings and making of investments. This means, however, that the legal provisions must also be enforced when the conditions that they regulate emerge. Otherwise the legal provisions lose their function to stabilize expectations.

Against this background, the bailout of numerous eurozone countries is problematic, as Art. 125 TFEU forbids a Member State from being liable for the commitments of another Member State.[16] While all players, who had put their trust in compliance with the no-bailout rule, were disappointed, those who had speculated that the law would be breached, were rewarded. As a

[14] See Voßwinkel (2013), p. 54.
[15] This cannot be seen as a reason for adopting as many legal provisions as possible.
[16] See Jeck/Van Roosebeke (2010).

result of this, the validity of other provisions of statutory law will be doubted in the future. The subsequent amendment to Art. 136 TFEU, which facilitated the establishment of the European Stability Mechanism and thereby made it possible for a bailout to take place, does not alter this, as legal provisions are only able to fulfil their stabilising function if they have been publicly disclosed before being applied.[17] Faith in the law and legislation has been severely damaged by the violation of the no-bailout rule and the amendment to Art. 136 TFEU. This has resulted in players shortening their planning periods because uncertainty about future developments has increased. In turn, the willingness to build up savings and make investments has decreased.

The numerous violations of the Stability and Growth Pact that have not been penalised have contributed significantly to the expectation among eurozone countries that they are under no obligation to observe the regulations of the Economic and Monetary Union. Even the reform to the Stability and Growth Pact will not change this consensus, as it envisages a number of exceptions that permit deviations from the pact's recommendations. These exceptions may make sense or, in some cases, may even be indispensable from an economic point of view. However, politically speaking other countries will lay claim to an exception as soon as it is granted to one eurozone Member State, even if the economic circumstances in these countries do not justify the use of such an exception. Political considerations mean this is unavoidable, particularly since the Commission and the other Member States rely on the cooperation of this country in other areas.

The first requirement for the sovereign default regime for the eurozone can be derived from the context and developments described above:

(1) The sovereign default regime must be developed in such a way that its enforcement is credible.

In other words, the binding legal consequences must actually be enforced in the event of a default as defined in the regime, because the sovereign default regime can only be effective if the players (politicians and investors alike) can rely on it being executed.

4.1.2 Entities must once again be held liable for their actions

Enforceable legal provisions may take a wide variety of forms. For example, the eurozone has the option of either effectively reinstating the no-bailout rule or foregoing it completely, so that in the future players may count on the insolvent eurozone country being bailed out.

One of the prerequisites for ensuring that the players are able to pursue and coordinate their individual plans unhindered is the principle of liability. This principle is fulfilled when the entity not only derives potential benefits from its actions but is also liable for potential damaging effects.[18] This forces players to consider exactly which risks they want to take. When entities are not held responsible for their actions, the greatest care will not be exercised when making investment decisions.[19]

The multiple bailouts of ailing eurozone countries have made the principle of liability largely ineffective. The investors who had been financing the government and current account deficits of some eurozone countries for a long period of time without adequately considering the risks involved have, to date, only contributed a negligible amount to the costs of the rescue package.

[17] See Hayek (2003), p. 92.
[18] See Eucken (2004), p. 279 et seq.
[19] See Eucken (2004), p. 280.

The 2010 Greece bailout brought unjust rewards to all of the investors who mistakenly considered Greece to be solvent or who speculated that such a bailout would take place. They benefited from raised interest rates for many years and were ultimately able to pass the risk of default on to the community of states. Players, on the other hand, who had correctly predicted the course of Greece's solvency and who had not speculated on a bailout were punished, as they had accepted a lower rate of return for many years.

While private players were held liable to a certain degree during the second Greek bailout in 2012 and the Cyprus bailout in 2013, the debt write-down came so late for Greek government bonds that investors had sufficient time to sell their government bonds and thereby transfer losses on to taxpayers partially or in full. Furthermore, the extent to which private players participated in supporting Cyrus did not even come close to covering the damage done, meaning that here, too, taxpayers were liable for part of the damage.

By announcing the unlimited purchase of government bonds via the OMT programme in September 2012, the ECB dispelled any remaining doubts that the principle of liability had been made ineffective systematically rather than just as an exception and also subsequently implemented corresponding purchases by way of the "Public Sector Purchase Programme".

The fact that entities are not responsible for their actions has led to wrong incentives for both investors and voters in their capacity as taxpayers:

If they are not held fully liable for their behaviour, investors will continue to provide countries looking for credit with capital, without sufficiently considering the risks or pricing the risk in an adequate way. This is because they do not at least have to take full responsibility for losses from the rash issuance of loans or purchase of government bonds. The suspension of the principle of liability therefore results in the investment practices of private investors preventing capital from being allocated efficiently. Hence, foreign capital is generally still available to Member States, and at interest costs that do not cover the risk of capital investments. This significantly reduces the pressure for reform and cements existing problems.

The fact that entities are not liable for their actions also means that voters are not being held fully accountable for the consequences of the choices they make during elections. Ultimately, it is up to voters to discipline politicians. They have the choice to never elect politicians whose election promises are expected to result in high government deficits or to vote out politicians who run up high government deficits during their terms of office. However, the opposite has already happened and indeed continues to occur. For example, by voting in Giorgios Papandreou in 2009, the Greeks succeeded in electing a politician who rode to victory in his election campaign with the promise that "There is money."[20] Although it was already clear to voters before the election that the government deficit was significantly higher than 3% of GDP (it ultimately rose to 9.8% of GDP), they still elected Papandreou.

Italy is an excellent example of the consequences of a lack of accountability. When the spreads on Italian government bonds rose significantly in 2011, it suddenly became possible for Silvio Berlusconi and his government to be driven out of office and for Mario Monti to be voted as prime minister with the explicit request for him to reform the country. Work began on making reforms but ground to a halt following the drop in spreads brought about by the ECB's announcement in September 2012 that it would purchase unlimited numbers of government bonds. It was therefore not without good reason that Italy's voters began asking themselves why painful reforms were still necessary and as a result Mario Monti and his reform programme suffered a crushing defeat in the

[20] Handelsblatt (2012): Brüchige Stimme, ernüchternde Bilanz, 11 March 2012.

2013 election. Further comprehensive reforms were announced by Prime Minister Mario Renzi, following his election into office by Parliament in February 2014, but these too became largely deadlocked. In Italy too, voters and members of parliament could rest assured that they would not have to bear the consequences of the choices they made during the election.

The fact that investors and voters have been released from being held accountable has reduced the incentives for politicians to maintain a sound budgetary position and implement structural reforms. To combat this, it was necessary to oblige eurozone countries receiving financial assistance to make reforms. However, this has been unable to change the subsequent expectation that the principle of liability will be suspended in similar cases in the future. To put an end to this expectation, a number of political coordination measures have been agreed since 2010 that, in particular, aim to make it clear that a renewed suspension of the principle of liability will no longer be required because in the future all countries will implement the necessary reforms before a further crisis can occur. This expectation was incorrect, however, as for the reasons already explained there is insufficient willingness among eurozone countries to make reforms when requested to do so from the outside. It is therefore doubtful, for example, that the reformed Stability and Growth Pact and the macroeconomic surveillance will be taken seriously.

It is rather the case that budgetary consolidation and structural reforms are only carried out in the event of increasing spreads. The development in Italy exemplifies this: Comprehensive efforts to implement cutbacks in expenditure and reforms were only first made in 2011 when Italy's refinancing costs rose in the course of the euro crisis. During previous periods of political coordination, no heed was paid to the requests of the European Commission, other Member States and the ECB. Also, the enthusiasm for austerity and reforms waned once the ECB announced the unlimited purchase of government bonds in an emergency, a development that immediately led to falling refinancing costs in Italy.

Thus, political coordination is unable to replace the disciplinary effect of the market, an effect for which the principle of liability is essential. Investors and voters will only create the pressure needed to encourage reforms and budgetary consolidation if they are liable in the event of their country becoming insolvent. Continuing to ignore the principle of liability will only lead to an increased level of risk taking among private investors, voters and political players alike, which in turn would make the re-emergence of a crisis more likely.

The second requirement for the sovereign default regime can be derived from these arguments:

(2) The sovereign default regime must be set out in such a way that both investors and voters in their capacity as taxpayers are liable for sovereign solvency problems.

4.1.3 Voters and national politicians must be able to decide for themselves once again

The fundamental problem in the eurozone is a meta-economic one[21]: On the one hand, the politicians and citizens of individual countries feel patronised by the national policy requirements imposed from outside. On the other hand, due to the different cultures and traditions in economic policy, there is no consensus among the eurozone countries about which measures should be taken to resolve the current crisis and present future crises. However, reforms and budgetary consolidation can only be implemented if the population is convinced of their necessity.

[21] See Chapter 3.

The fact that the Commission's recommendations and requirements are often unnecessarily detailed is of particular consequence here. All that matters for the survival of the euro is *that* every eurozone country has a sustainable level of debt and a thriving national economy. *How* this is achieved is irrelevant. It should therefore be left to each state to decide whether to reduce new debts by raising taxes, curbing expenditure or stimulating economic growth. And it should be left to each government whether to ensure high competitiveness by deregulating the labour markets, reducing non-wage labour costs or promoting sunrise industries.

The third requirement can be derived from this:

(3) A sovereign default regime should allow each country to define for itself the timing, type and scope of reforms.

4.1.4 The need for reforms must be identifiable at an early stage

To allow room for manoeuvre in the content and timing of various reform options, the need for reform must be identified in good time. A crucial problem in the financial and euro crisis was that events unfolded very quickly. Greece's sovereign default, which actually occurred in the spring of 2010, had not been seen to emerge over a matter of years; instead, it became an urgent matter within a few months, if not weeks.

Identifying a need for reform early on stems the risk of contagion, which was a threat during the euro crisis. If several eurozone countries have dubious levels of debt sustainability, sovereign default in one country can spread to another. The bail out policy introduced in 2010 came not least as a response to the fear of mutual contagion.

The fourth requirement can be derived from this:

(4) The sovereign default regime must allow developments that threaten the solvency of a State to be brought to light at an early stage.

4.1.5 States must be (partially-) shielded from the insolvency of financial institutions

During the financial crisis, many eurozone countries kept national financial institutions alive with capital injections because of their relevance to the financial system (too big to fail theory). The insolvency of such major financial institutions may well trigger the insolvency of other financial institutions due to the strong credit ties between them. At worst, this may lead to the collapse of a country's entire financial system, with the supply of credit to companies breaking down, and wages and salaries no longer being paid out. Ultimately, capital controls would have to be established. In order to prevent this, the state must protect the affected financial institution from collapse using government aid. However, if the sums needed to rescue these financial institutions put too much of a strain on the national budget, the State itself is at risk of sovereign default – as in the cases of Ireland, Spain and Cyprus. However: All eurozone countries still have a range of ways in which to use economic and finance policy to exert material influence on the size of their domestic finance sector and its sensitivity to risk. For reasons of incentive, it would not therefore be productive to completely shield countries from the costs resulting from bank failures.

The fifth requirement is a logical conclusion of the above points:

(5) The sovereign default regime must be able to ensure that imbalances in the financial sector do not, as a rule, threaten state solvency.

4.1.6 Financial institutions must be shielded from sovereign default

In the financial crisis and the concomitant recession, all eurozone countries incurred huge new debts which ultimately jeopardised the solvency of southern European countries and Ireland. Financial institutions, most notably banks and insurance companies – and not only domestic ones – were the major creditors. The majority of financial institutions across the eurozone were affected.

It was therefore feared that sovereign default in one eurozone country would even jeopardise the existence of financial institutions in other eurozone countries. If sovereign default forces foreign banks or insurance companies to undertake such large depreciations on their government bonds that their equity is used up, their insolvency becomes inevitable. This could be observed in some cases in Cyprus: Cypriot banks had to accept such great losses due to the sovereign haircut in Greece that they became insolvent.[22]

If the affected foreign financial institutions are systemically important, the collapse of the entire financial system as outlined above is a threat, even outside of the insolvent eurozone country. In order to prevent this, these banks must also be rescued by the state. However, rescuing banks that are systemically important can quickly exceed the abilities of the affected countries which in turn may lead to sovereign default in other eurozone countries.

This gives rise to the sixth requirement:

(6) The sovereign default regime must allow financial institutions to be able to withstand the insolvency of the state.

4.1.7 Summary of requirements for a sovereign default regime in the eurozone

A sovereign default regime must be developed in such a way that:

(1) its enforcement is credible;

(2) both investors and voters in their capacity as tax-payers are liable for sovereign solvency problems;

(3) each country is able to define for itself the timing, type and scope of reforms;

(4) any developments that threaten the solvency of a state become obvious at an early stage;

(5) imbalances in the financial sector cannot threaten sovereign solvency and

(6) financial institutions can cope with the sovereign default.

[22] Mismanagement, corruption and lax supervision also played a significant role in the matter.

4.2 The key element: early, automatic sovereign haircut

4.2.1 Enabling sovereign defaults

The principle of liability implies the possibility – and indeed necessity – for eurozone countries to be able to default and for the costs of such an insolvency to be covered by those responsible alone. On the one hand, this means the investors who made investment decisions, on their own responsibility, to lend money to the affected country in the form of loans or purchasing government bonds. On the other hand, it means the national populations in their capacity as voters and taxpayers, because they are the ones acting as "principal" for national politicians ("agents") who have permitted or even brought about the over-indebtedness. Therefore, sovereign default may and indeed should no longer be prevented or delayed by financial assistance from other eurozone countries if the principle of liability is to be applied.

4.2.2 Preventing uncontrolled and enforcing controlled sovereign defaults

The scale of the debt and euro crisis is not least attributable to the fact that the imminent insolvencies in 2010, first in Greece and then in other states, were identified much too late.

This was particularly due to the fact that it is impossible to accurately determine a country's debt sustainability. It is affected by too many factors, including potential growth of the gross domestic product, taxing capacity, private assets, competitiveness and current account balance. Nevertheless, investors form expectations about a country's maximum debt sustainability in order to be able to determine the probability of default and, thus, a risk-appropriate interest rate. In doing so, they also consider how the aforementioned factors are expected to develop. In the case of Greece, many investors suddenly lowered their expectations after the financial crisis led to a sharp increase in new debt and the newly elected Greek government announced that the published budget statistics had been heavily whitewashed for years. The risk of default skyrocketed as a result. This prompted many investors to sell their Greek government bonds and refrain from acquiring new bonds, leading to considerably higher interest on new debts. As increasing interest rates reduce the maximum sustainable debt burden, the risk of default continued to grow. This situation persisted until Greece was effectively on the brink of default.

The above clearly shows that the expectations of international investors are of crucial significance: as long as they do not change their expectations about the solvency of a state and thus continue to grant credit, the state is able to service its due debts. However, a lack of knowledge about the future development of potential growth, taxing capacity and competitiveness leads to uncertainty among investors about the maximum sustainable level of debt. This uncertainty can prompt herd behaviour (panic sales) and have domino effects in other states (contagion). If several large investors sell off a country's government bonds within a short period of time because their expectations have changed, other investors will also sell off these investments. In addition, this is accompanied by a growing concern that other countries could also slide into default, with the result that those states' bonds are also sold off. Both of these occurrences become more likely the closer a state comes to its maximum sustainable level of debt as estimated by the investors. In light of these circumstances, **uncontrolled default**, the effects of which – it was feared – were not foreseeable and therefore also uncontrollable, posed a threat in 2010.

This risk of uncontrolled default gave the eurozone countries a significant motive to contravene the no-bailout rule in order to stabilise Greece in March 2010 and initiate the European Financial Stability Facility in May 2010, which was then also used to keep Ireland and Portugal afloat. In other words, the risk of uncontrolled default was a decisive reason for contravening the applicable law of the European Treaties and suspending the principle of liability, with politicians choosing the option that presented the lowest risk – at least in the short term.[23] This strategy is comprehensible, and it is naive to think that different political actions would be taken in a similar situation in the future. and it is naive to think that different political actions would be taken in a similar situation in the future.

By implication therefore: if compliance with applicable law and the principle of liability are once again to become pillars of the European legal system, uncontrolled default must no longer be a cause for concern to active politicians.

This is only possible if states go into controlled default before they snowball into uncontrolled default. The sovereign default regime developed herein therefore requires, as a key element, that sovereign haircuts occur a significant amount of time before debts cease to be sustainable.

This would mean that changes in capital market players' expectations for a country would only lead to relatively minor increases in interest, because the risk of default would only rise slightly. This would in turn minimise herd behaviour and domino effects and, ideally, even prevent them altogether.

4.2.3 Sovereign haircut rule

We propose that a universally applicable, fixed reference value be determined, which, when reached, triggers a sovereign haircut.[24] This has four important advantages.

Firstly, it makes it is easier for investors to anticipate the risk of losing part of their money through a sovereign haircut. Sudden changes to the risk assessment and concomitant abrupt increases in interest will give way to a successive rise in spreads if the state in question approaches the reference value. Psychologically conditioned "panic sales" and "contagion" in other eurozone countries are avoided.

Secondly, gradually increasing spreads leads to a slow but constant increase in the pressure on states to gain control of their government budgets. This gives the state sufficient time to take corrective measures. As a result, national politicians are neither misguided by the illusory assurance that budgetary consolidation is not yet necessary, nor are they suddenly confronted with doubts about their country's debt sustainability obliging them to take hasty countermeasures that in turn propel the country into economic downturn and cause the further erosion of debt sustainability. Eurozone countries, that have been forced to make tough budgetary consolidations, have repeatedly referred to this spiral of events in recent years as "the adverse effects of austerity".

Thirdly, the citizens of each country are able to form clear expectations. If a state approaches the reference value, credit financing from abroad becomes more expensive not only for the state, but also for businesses and consumers. The latter therefore have sufficient time and opportunity, by the next election at the latest, to punish the government for the behaviour that is causing the debt level to rise and to call for political change. Businesses and citizens who hold government bonds themselves have an even more powerful incentive to demand change.

[23] Furthermore, it was feared that an insolvent Greece would leave the eurozone, a situation that many politicians wanted to prevent for reasons of integration policy.
[24] See Eichengreen (2011).

Fourthly, the proposed sovereign haircut rule inhibits a situation that is repeatedly observed ahead of sovereign defaults: There are strong incentives for governments to delay insolvency for as long as possible – ultimately until the loss of debt sustainability becomes evident.[25] They wish to evade the costs that accompany insolvency, as well as the damage to personal reputation that can lead to the loss of political office. However, in the case of a delayed insolvency, the costs are higher than actually necessary for both debtors and lenders.

As the debt sustainability limit of a state cannot be precisely determined in advance, it is essential that the reference value is always lower than the – unknown – limit of sustainability. Admittedly, this may mean that a state approaching the reference value may not make an investment for lack of capacity for new debt, in order to avoid exceeding the value or even merely to prevent rising spreads. However, the advantages detailed above significantly outweigh this disadvantage. In addition, it has been shown in the past that politicians frequently and gladly misuse debt-financed investments as an excuse to raise public spending. During the crisis, it became clear that many government infrastructure investments in Europe were unprofitable.

4.2.4 Definition and amount of the reference value

We propose that the reference value at which a sovereign haircut is compulsory be defined using the **ratio of the total level of public debt to the gross domestic product** (GDP). We also propose that the reference value stand at **90%**. According to this, a haircut must be performed as soon as the level of debt of a eurozone country reaches the limit of 90% of GDP.

There are two reasons for using this value: Firstly, a debt level of 90% of GDP is sustainable for all eurozone countries, meaning there is no risk of sovereign default before this point. Secondly, the proposed reference value is much higher than the value of 60% permitted by the Stability and Growth Pact. This gives the state in question sufficient scope to reduce its debt level once it has exceeded the 60% threshold, and it may do so without having to reckon with a significant increase in the interest rate risk premium, as would certainly be the case with a reference value of around 70%.

In eurozone countries with a federal state structure, where individual local authorities are not liable for the debts of others, those authorities with a low level of debt should not be obliged to perform a haircut if other local authorities have become heavily indebted and the country as a whole consequently exceeds the 90% threshold. Therefore, in such cases, joint and several liability should be excludable, even in the event of a haircut. This must, however, be determined from the start and on a permanent basis. An adjusted standard for comparison, e.g. GDP according to region, is also taken into account here.

It is up to an independent institution outside of the country in question to determine whether a eurozone country has reached the reference value. The European Commission could be this institution. The evaluation should take place annually.

[25] ee Krueger (2002).

4.2.5 Size of the haircut

We propose that when the reference value is reached, a haircut of **10% of the total debt** be triggered. The government debt level will therefore amount to 81% of GDP after a haircut.

This is because the haircut should be fixed at a size that causes as little economic disruption as possible.

On the one hand, it must be low enough so that the resulting loss and corresponding write-downs do not overstrain investors. Particular care should be taken to avoid financial institutions, especially banks and insurance companies, being pushed to the brink of insolvency themselves as a result of the haircut. In addition, the resulting economic disruption in the country performing the haircut is smaller the smaller the haircut. Both of these factors are therefore also very important because they raise the credibility of the haircut rule as a whole. If the solvency of financial institutions is not jeopardised by the haircut and the economic disruptions are calculable, investors must expect that the haircut will actually be performed. This credibility is a prerequisite for the investors to raise spreads in the event of increasing government debts, thereby prompting the politicians of the country in question to take countermeasures.

On the other hand, the haircut must be high enough that investors need not fear another such process occurring in the foreseeable future. This is essential because investors would naturally anticipate another haircut and states would be unable to refinance existing debts as a result of this expectation.

A debt haircut of 10% takes both of these aspects into account.

In order to ease refinancing after a haircut, new credit could be excluded from a renewed haircut for a certain period of time, e.g. two years. This of course runs the risk of the strict rules of the default regime being undermined.

It is essentially possible, if unlikely, for a bond to be affected by a haircut more than once. This is the case if the reference value is reached again during the term of the bond although a haircut has already been performed.

4.2.6 Automatic hair-cut

The haircut must be compulsory and therefore triggered automatically. This is essential because there are strong incentives for lenders, as well as for the state in question, to delay or even dispense a haircut once the reference value has been reached. Lenders must first of all carry out fewer write-downs. Countries would wish to avoid the higher spreads that are highly likely to follow a haircut.

These double-sided incentives present a particularly volatile problem because the haircut rule requires a haircut that is significantly lower than the debt sustainability limit. Delaying a haircut would therefore not have any serious direct consequences at first. On the contrary, the delay could even mean that risk premiums temporarily fall in the short term.

In this context, automatism is indispensable for two reasons. Firstly, delaying a haircut leads in the medium term to increased insolvency costs for both lenders and the affected state, meaning that the resistance to a haircut continues to grow. Continued delays to a haircut run the risk of it being renounced altogether.

Secondly and above all, the proposed sovereign default regime greatly depends on the credibility of its implementation. If investors are able to speculate that debt will not be written down in the end after all, they will not demand any corresponding risk premiums in the event of government debt that is gradually approaching the reference value. Instead, they will wait for evidence that the state may have reached its debt sustainability limit. Furthermore, states will not take sufficient countermeasures to gain control of their debts from the outset if they are able to speculate that they can avoid a haircut despite having reached the reference value.

As a whole, hardly anything would be gained in comparison to the current circumstances. Instead of controlled sovereign defaults, uncontrolled sovereign defaults would carry on presenting a risk, against which politicians would continue to act with ad hoc rescue attempts, bringing all the aforementioned consequences with them. The principle of liability would still not be enforced.

Automatism is therefore essential. All government bonds newly issued by eurozone countries must contain a provision for haircut to take place as soon as the state's level of debt reaches 90%.[26]

4.2.7 Transitional Arrangement

The sovereign haircut rule, which prescribes an obligatory haircut of 10% upon reaching a debt level of 90% of GDP, would enforce an immediate haircut in the eight eurozone Member States – Belgium, France, Greece, Ireland, Italy, Portugal Spain and Cyprus – whose debt already exceeds this level today, in some cases to a considerable extent. It would, therefore, be impossible to apply this rule in these countries straight away. A number of other eurozone countries are approaching this reference value of 90%. Immediately applying the sovereign haircut rule on these countries would not only meet with political resistance but would also be counterproductive, as risk premiums would rise instantly in anticipation of the impending 10% haircut.

Furthermore, in the years immediately following the application of the sovereign haircut rule, many old bonds are still in circulation that for legal reasons may not be subject to the haircut rule. This means that the extent to which the debts are reduced is initially significantly lower than 10%, running the risk that another haircut could be required within a short period of time. This presents another reason why a transitional arrangement is needed.

In light of this, we propose the following transitional reference values: **Sovereign haircuts** must be performed in eurozone countries **where** the level of debt exceeded 75% of GDP in 2014 if their **level of debt is 15 percentage points higher than that of 2014**. In subsequent years, the transitional reference value is **reduced by one percentage point annually** until it reaches 90%.

Table 1 shows the effects that this would have on individual eurozone countries if the sovereign default regime were to be introduced in 2016.

[26] For legal reasons, such a provision cannot be uniformly applied to government bonds already issued.

Table 1: Transitional Arrangement

Eurozone Country	Level of debt in 2014 (in % of GDP)	2016 Transitional reference value
Estonia	11%	–
Luxembourg	24%	–
Slovakia	54%	–
Finland	59%	–
Malta	68%	–
Netherlands	69%	–
Germany	75%	–
Slovenia	81%	96%
Austria	85%	100%
France	95%	110%
Spain	98%	113%
Belgium	107%	122%
Cyprus *	108%	123%
Ireland	110%	125%
Portugal	130%	145%
Italy	132%	147%
Greece *	177%	192%

* Cyprus and Greece currently have only limited access to the capital market, meaning that the transitional arrangement can only be applied at a later point in time

As an example, the following figures have been calculated for Italy: In 2014, the level of debt amounted to 132% of GDP, resulting in a transitional reference value of 142%. From these figures, a sovereign haircut would be carried out if the level of debt amounted to 147% of GDP in 2016, 146% in 2017, 145% in 2018 and 144% in 2019, etc. In 2029, the transitional reference value would be 132%, which would correspond to the level of debt in 2014. The target reference value of 90% would finally be achieved in 2073. All government bonds issued from 2014 on must contain appropriate provisions for the respective relevant durations.

The additional scope for debt of 15% of GDP and the long transitional period until the reference value of 90% is reached have been set with two aims in mind. Firstly, the individual eurozone countries must be given the opportunity to trial various policies and reforms according to their national preferences as well as to turn their ideas for appropriate fiscal and economic policies into reality. This allows a country to choose for itself how and at what speed to carry out budgetary consolidation, factors that are currently prescribed by the Stability and Growth Pact and Fiscal Compact. This would not be possible if a sovereign haircut were imminent within a few years. Secondly, more room for manoeuvre and longer periods in which changes can be made during the transitional stage will make the citizens and political decision makers in the eurozone countries more likely to accept the proposed sovereign default regime.

The effects of the transitional arrangement become clear by drawing on the example of Italy: Over the next few years, the debt write-down rule will only have minimal effects on the country's refinancing conditions. A bond with a three-year maturity would probably be relatively simple to issue in 2016, as it is unlikely that Italy's level of debt would reach the admissible value of 144% of GDP by the time that this bond matures in 2019; the buyers of this bond are therefore not exposed to any serious risk of default. The situation is different for ten-year bonds, however. If the buyers of the bond want to avoid writing down the debt, the level of debt must be lower than 137% when the bond matures in 2026, a figure that is only five percentage points more than that of 2014. This means that Italy has no option but to reduce its level of debt in the near future: The distance between the level of debt and the transitional reference value which would trigger a sovereign haircut is becoming ever smaller. 2031 marks the year in which the transitional reference value of 132% matches 2014's level of government debt, and in order for the country to avoid high interest rates, its level of debt must be significantly less than this figure long before then.

The transitional scenario assumes that refinancing will take place completely via the capital market. It cannot therefore be used in eurozone Member States that have no or only limited access to the capital market, which currently applies to Greece and Cyprus. The countries in question may only use the transitional scenario once the ongoing adjustment programmes have been successfully concluded.

4.3 Accompanying provisions

4.3.1 Preventing new debt via the ECB's TARGET system

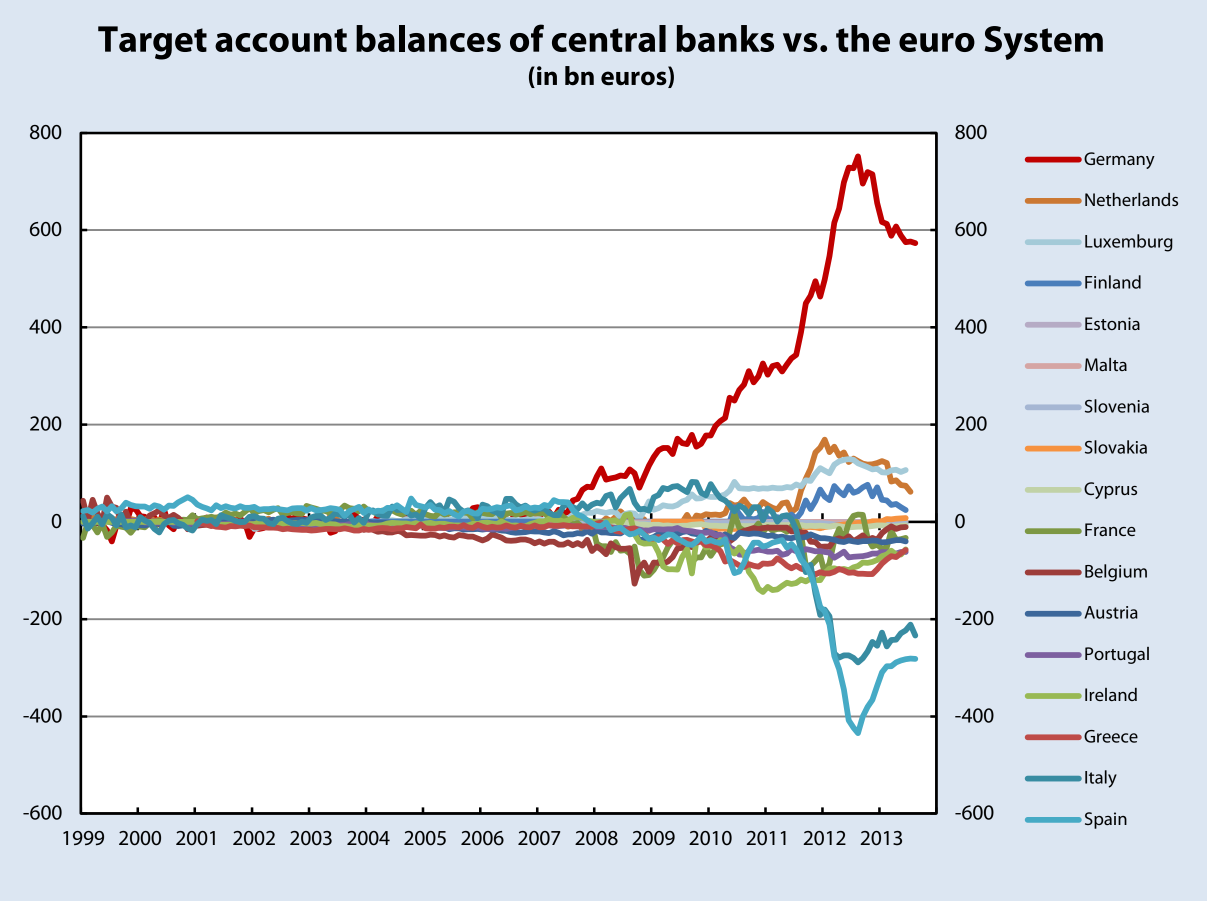
The proposed sovereign default regime relies on the disciplining effect of risk premiums on interest rates (spreads) increasing slowly rather than ad hoc. Investors will demand such spreads upon investing in government bonds of a country which public debt level approaches the reference value. This in turn creates an incentive for national governments to make timely reform and consolidation efforts.

A prerequisite for this knock-on effect is that eurozone countries must no longer be allowed to run up debts via the ECB's TARGET system instead of via the capital market.

Currently, the net borrowing requirements of low-performing countries which foreign private investors are no longer prepared to finance are covered by the ECB's TARGET system. In this way, charges can be passed on to third parties. The Deutsche Bundesbank had aggregated TARGET claims of 532 billion euros in April 2015. In contrast, the aggregated TARGET liabilities of the central banks of Greece (96 bn euros), Portugal (53 bn euros), Spain (212 bn euros), Italy (177 bn euros) and

Cyprus (2.5 bn euros) amount to a total of 540 billion euros.[27] In light of this, the ECB's TARGET system must in any case be reformed.

Figure 1: TARGET account balance of central banks (in billion euros)



Source: Ifo Institute (2015) as at 8 May 2015.

This is also necessary for the effectiveness of the sovereign default regime. A steady reduction of TARGET imbalances would be advisable. The scope and speed at which this would be manageable for the fragile economies of southern Europe must be evaluated in detail. The minimum requirement should be, however, that TARGET claims and liabilities may not increase any further.

A procedure is therefore required that obligatorily settles the TARGET account balances once a year. A suggestion for this would be the procedure used in the USA.[28] The Federal Reserve System consists of twelve districts, between which account balances similar to those in the TARGET system accrue over the year. These are settled annually, by districts with TARGET liabilities transferring securities that are tradable on the capital market to districts with TARGET claims.

A rule of this kind means that a country's credit requirement to be covered from abroad is settled via the capital market. In this case, risk-appropriate spreads will apply, which is not the case within the TARGET system.

[27] Source: Ifo Institute (2015)
[28] Sinn (2012), p. 14 and p. 40.

4.3.2 Accompanying measures to (partially) shield governments from the default of financial institutions.

The principle of liability must also be applicable *for the benefit* of governments. It is precisely because the proposed sovereign default regime demands a responsible fiscal policy from national governments that this must not be subverted by these governments having to save financial institutions from default with billions in financial aid in order to prevent the financial system from collapsing. Rescue operations of this kind scupper political efforts to reduce government debt by means of reforms. They are also detrimental to the public's willingness to support such reforms.

At the same time, however, all eurozone countries still have a range of ways in which to use economic and finance policy to exert material influence on the size of their domestic finance sector and its sensitivity to risk. For reasons of incentive, it would not therefore be productive to completely shield countries from the costs resulting from bank failures.

On this basis, it is necessary for all financial institutions to be fundamentally able to sustain their own losses. For this, stricter capital requirements and commensurate supervision over the institutions are needed. Financial institutions' ability to sustain their losses has rightly been strengthened in recent years (keywords: "Basel III"[29] and "Solvency II"[30]). While the qualitative and quantitative **capital requirements were raised** for banks with Basel III, Solvency II introduces a risk-based capital requirement for insurance companies, for the first time. These changes must now be quickly implemented. **Supervision of banks** and investment firms in the eurozone has rightly been centralised. In Autumn 2014, the European Central Bank took on supervision of the largest banks in the eurozone. [31]

However: Even strict capital requirements and effective banking supervision cannot be absolutely certain of preventing financial institutions from suffering unsustainable losses. Resilient rules therefore need to be in place, which allow the resolution of such financial institutions to take place without government aid if at all possible. The **uniform European rules on bank resolution** (Directive for recovery and resolution and Regulation on a single resolution mechanism) which will be fully applicable as of 2016, are appropriate in this regard and therefore to be welcomed.[32]

The importance of plausible resolution rules cannot be overstated. Not only do they protect public budgets in cases of financial crisis but also reduce the probability of such crises occurring in the first place: If owners and creditors actually have to anticipate the resolution of a financial institution, there is a risk of losses of capital employed or of claims. Owners and creditors will price in these risks, which will raise the bank's capital cost, putting pressure on the bank's management not to take excessive risks.

The new rules provide that in the event of a bank resolution, both the owners and the creditors are initially liable for losses using capital to absorb losses and convert debt claims to equity ("bail-in"). If

[29] Directive 2013/36/EU of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms and Regulation (EU) No 575/2013 of 26 June 2013 on prudential requirements for credit institutions and investment firms.

[30] Directive 2009/138/EC of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance.

[31] Regardless of whether centralisation is right, the question of which European authority should be responsible for banking supervision must be addressed. Charging the European Central Bank with this task is economically questionable and, in addition, contravenes European primary legislation (see cepPolicyBrief 47/2012).

[32] Directive 2014/59/EU and Regulation (EU) No. 806/2014.

this is not sufficient, the holders of savings and other deposits, that are over the deposit guarantee scheme limit (currently 100,000 euros), will also be liable.

Where there are any residual resolution costs, the Single Bank Resolution Fund will come into operation on behalf of eurozone countries. This fund is supplied with compulsory contributions from eurozone banks and within eight years must have at least 1% of the deposits covered by deposit guarantee schemes (approx. 55 billion euro).[33,34] The contributions at national level will be mutualised gradually over a period of eight years.

Overall, these rules reduce the fiscal costs of a bank resolution. In the case of the resolution of smaller banks, the liability of owners, creditors and savers and the use of the Single Bank Resolution Fund, could have the result that no tax funds have to be used at all. This is not necessarily the case for larger banks.

The question of how to deal with the residual resolution costs also arises in relation to the sovereign default regime proposed here. We cannot see a general answer to this problem but propose four different options depending on the situation.

(1) The Member State concerned bears the remaining costs of a bank resolution.

(2) The ESM issues a dedicated loan – as is already possible under current law – to the Member State which has to use it for the recapitalisation of the affected bank. This loan is linked to sector-specific requirements and increases and raises the debt level of the country. It can therefore (but need not) jeopardise access to the capital market.

(3) Where an ESM-loan jeopardises access to the capital market – as already provided for under existing law – a direct recapitalisation of the affected bank by the ESM will take place. The debt level of the country will not be affected by this.[35] This instrument requires, however, inter alia that the country makes its own contribution of 10 % of the recapitalisation costs.

(4) The ESM issues a loan to the European Bank Resolution Fund – this is not currently provided for.[36] The requirement for this should be that the country has made its own contribution to the recapitalisation costs.

These instruments differ not least in the extent to which the respective country must contribute to the residual costs of a bank resolution. The choice of instrument therefore has direct impact on the likelihood of an automatic haircut. Depending on the scenario, it may be more or less advisable to impose these costs on the country. Where national policy deliberately accepts higher risks - such as where corporation tax regulations have the aim of establishing a finance centre which will entail corresponding tax revenue but also certain risks - there is a great deal to be said for Options 1 and 2. In the case of minor misdemeanours in national policy, Options 3 and 4 are favourable.

Although the European Commission's proposals for bank resolutions – aside from setting up a bank resolution fund for the eurozone – are a step in the right direction, there are no comparable rules for insurance companies. This must be amended, taking into account the vast differences between banks and insurance companies. Insurance companies – unlike banks – are less exposed to the risk of sudden loss of liquidity.

[33] In non-eurozone countries, there is recourse to inter alia national bank resolution funds, supplied with compulsory contributions from the national banks.
[34] Art. 69 SRM Regulation (EU) No. 806/2014.
[35] Although only up to a maximum of 60 billion euro; see Van Roosebeke (2014).
[36] The pros and cons are discussed by Van Roosebeke (2014).

4.3.3 Shielding financial institutions from sovereign default

Controlled sovereign default will cause losses at financial institutions that have provided credit to, or bought bonds from that government. This is necessary in order to make banks charge risk-appropriate risk premiums which in turn prompt the State to maintain a sound budgetary policy. Nevertheless, the financial institutions must also be able to bear these haircut losses. They must not be driven into default themselves as a result of sovereign default. Otherwise there is a risk of entering the aforementioned spiral of intervention, in which States are forced to provide assistance to the national banks, which in turn may cause them to default.

The probability of the financial institutions being able to cope with a controlled sovereign default is much higher than for an uncontrolled default, simply because the losses resulting from a single sovereign haircut are limited to ten per cent of the nominal value of the claims against the affected Member State. However, this does not entirely exclude the possibility of financial institutions running into very serious difficulties. Such a situation could arise, for example, if individual financial institutions were exposed to the multiple controlled defaults of different countries within a short period of time.

Statutory provisions are therefore needed that force financial institutions to take precautions enabling them to cope with such situations.

Firstly, adequate **capital requirements for government bonds** are essential. The financial and euro crisis has made it more than clear that even government bonds and credits to governments are at risk of default. The sovereign default regime proposed herein in fact explicitly enforces a controlled default if the reference value is reached, and with it, a haircut of ten per cent of bonds held and credits given. Adequate capital requirements can help absorb the financial shock of such a haircut without jeopardising the existence of the financial institutions affected by it. Indeed, the capital requirements for banks, "Basel III"[37], and for insurance companies, "Solvency II"[38], were tightened in response to the financial and euro crisis. However, compulsory capital requirements for government bonds have not yet been introduced. This must be corrected. Just like the automatic haircut, compulsory capital requirements for government bonds would make borrowing for eurozone countries more expensive. This would ultimately internalise external costs, which are currently not taken into consideration. For lack of plausible alternatives, the risk weights for government bonds should be based on ratings from registered rating agencies.[39]

Secondly, an **upper limit for the total volume of government bonds held by a financial institution – from all countries** – should be introduced, which could be measured as a percentage of the balance sheet total. This upper limit can be supplementary to the compulsory capital requirements for government bonds. This is absolutely essential, at least during the transitional phase leading to such capital requirement. An upper limit is advisable, above all, if one believes the risk of default not being properly estimated by rating agencies.

Thirdly, an **upper limit for the volume of government bonds held by a financial institution from one single government** should be introduced. This provision prevents risk concentration in financial institutions that can generate unsustainable losses in cases of sovereign haircuts, despite capital requirements.

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[37] Directive 2013/36/EU of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms and Regulation (EU) No 575/2013 of 26 June 2013 on prudential requirements for credit institutions and investment firms.

[38] Directive 2009/138/EC of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance.

[39] For consistency's sake, the ECB would have to take the credit standing of each Member State into consideration as well when banks use sovereign bonds as security upon refinancing at the ECB.

Fourthly, the implied obligation for financial institutions to invest in government bonds should be removed. The concrete structure of the planned liquidity key figures for banks must not lead to banks only being able to fulfil the liquidity requirements by investing in (mostly highly liquid) government bonds on a large scale.

4.4 Analysis of the sovereign default regime in light of the requirements

The following table provides an overview of the extent to which the individual elements of the proposed sovereign default regime contribute to fulfilling the requirements as outlined above.

Table 2: Overview of the sovereign default regime and the function of single elements thereof

Requirements	Sovereign Default Regime				Characteristics
	Key Element	Accompanying Provisions			
	Early, automatic sovereign haircut	Preventing new debt via the TARGET System	Shielding States from the default of financial institutions	Shielding financial institutions from sovereign default	
Credible enforcement	✓				✓
Liability of Investors and voters, not of foreign tax-payers	✓	✓	✓		✓
Country being able to define timing, type and scope of reforms	✓	✓			✓
Solvency threats becoming obvious at an early stage	✓				✓
Shielding States from the default of financial institutions			✓		✓
Shielding financial institutions from sovereign default	✓			✓	✓

5 Legal transposition of the measures

In what follows, the main amendments, that have shown to be necessary for the transposition of the proposed measures, are presented in a tabular form. The amendments concern the TFEU (see 5.1), the ESM-Treaty (see 5.2) and the "Collective Action Clauses" (CAC) (see 5.3) for government securities that have been elaborated by the Economic and Financial Committee (EFC).

In order to ensure that euro area Member States may choose the timing and the type of economic policy reforms or budgetary consolidation themselves, all within the framework laid out in chapter 4, the requirements to economic policy and fiscal surveillance of the euro area Member States must be amended. The provisions of the Stability and Growth Pact[40] should be made non-binding and sanctions should be dropped. The same holds for the newly established macroeconomic surveillance. For this reason, the provisions of the Regulation (EU) No 1174/2011 and No 1176/2011 can no longer be binding to euro area Member States, as with the provisions for the monitoring of draft budgetary plans [Regulation (EU) No 473/2013], the measures for euro area Member States experiencing or threatened with serious difficulties with respect to their financial stability [Regulation (EU) No 472/2013], the requirements for budgetary frameworks of euro area Member States [Directive 2011/85/EU] and the provisions of the Fiscal Pact.

Moreover should the ECB reform the TARGET2-system[41] in ways that have been laid out in the above.

[40] Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure and Regulation (EU) No 1173/2011 on the effective enforcement of budgetary surveillance in the euro area.

[41] Guideline (ECB/2012/27) of the ECB of 5 December 2012 on a Trans-European Automated Real-time Gross settlement Express Transfer system (TARGET2).

5.1 Amendments to the TFEU

Article 136 (3) TFEU has been included in the TFEU as a so-called opening clause, that would allow euro area Member States to establish a stability mechanism that could ensure the stability to the euro area. To avoid the establishment of mechanisms that extend beyond the financing of resolutions of financial institutions in the future, the opening clause needs to be amended.

In addition, the provisions of article 126 TFEU shall be of non-binding nature and sanctions should be dropped.

	Amendments	TFEU
Opening clause	Article 136 paragraph 3 new version	Article 136 paragraph 3 previous version
	The Member States whose currency is the euro may establish a *mechanism for financial assistance to fund the resolution of financial institutes. The conditions for its activation will be set separately by those states.*	The Member States whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality.
Excessive government deficits	Article 126 new version	Article 126 previous version
	(1) To repeal.	(1) Member States shall avoid excessive government deficits.
	(2) to (8) No amendments.	(2) The Commission shall monitor the development of the budgetary situation and of the stock of government debt in the Member States with a view to identifying gross errors. In particular it shall examine compliance with budgetary discipline on the basis of the following two criteria: a) whether the ratio of the planned or actual government deficit to gross domestic product exceeds a reference value, unless: - either the ratio has declined substantially and continuously and reached a level that comes close to the reference value, - or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value;

		b) whether the ratio of government debt to gross domestic product exceeds a reference value, unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace. The reference values are specified in the Protocol on the excessive deficit procedure annexed to the Treaties. (3) If a Member State does not fulfil the requirements under one or both of these criteria, the Commission shall prepare a report. The report of the Commission shall also take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State. The Commission may also prepare a report if, notwithstanding the fulfilment of the requirements under the criteria, it is of the opinion that there is a risk of an excessive deficit in a Member State. (4) The Economic and Financial Committee shall formulate an opinion on the report of the Commission. (5) If the Commission considers that an excessive deficit in a Member State exists or may occur, it shall address an opinion to the Member State concerned and shall inform the Council accordingly. (6) The Council shall, on a proposal from the Commission, and having considered any observations which the Member State concerned may wish to make, decide after an overall assessment whether an excessive deficit exists. (7) Where the Council decides, in accordance with paragraph 6, that an excessive deficit exists, it shall adopt, without undue delay, on a

		recommendation from the Commission, recommendations addressed to the Member State concerned with a view to bringing that situation to an end within a given period. Subject to the provisions of paragraph 8, these recommendations shall not be made public.
		(8) Where it establishes that there has been no effective action in response to its recommendations within the period laid down, the Council may make its recommendations public.
	(9) To repeal.	(9) If a Member State persists in failing to put into practice the recommendations of the Council, the Council may decide to give notice to the Member State to take, within a specified time limit, measures for the deficit reduction which is judged necessary by the Council in order to remedy the situation. In such a case, the Council may request the Member State concerned to submit reports in accordance with a specific timetable in order to examine the adjustment efforts of that Member State.
	(10) The right to bring actions provided for in Articles 258 and 259 may not be exercised within the framework of paragraphs 1 to *8* of this Article.	(10) The rights to bring actions provided for in Articles 258 and 259 may not be exercised within the framework of paragraphs 1 to 9 of this Article.
	(11) To repeal.	(11) As long as a Member State fails to comply with a decision taken in accordance with paragraph 9, the Council may decide to apply or, as the case may be, intensify one or more of the following measures: - to require the Member State concerned to publish additional information, to be specified by the Council, before issuing bonds and securities, - to invite the European Investment Bank to reconsider its lending policy towards the Member State concerned, - to require the Member State concerned

		to make a non-interest-bearing deposit of an appropriate size with the Union until the excessive deficit has, in the view of the Council, been corrected, - to impose fines of an appropriate size. The President of the Council shall inform the European Parliament of the decisions taken.
	(12) The Council shall abrogate some or all of its decisions or recommendations referred to in paragraphs 6 to *8* to the extent that the excessive deficit in the Member State concerned has, in the view of the Council, been corrected. If the Council has previously made public recommendations, it shall, as soon as the decision under paragraph 8 has been abrogated, make a public statement that an excessive deficit in the Member State concerned no longer exists.	(12) The Council shall abrogate some or all of its decisions or recommendations referred to in paragraphs 6 to 9 and 11 to the extent that the excessive deficit in the Member State concerned has, in the view of the Council, been corrected. If the Council has previously made public recommendations, it shall, as soon as the decision under paragraph 8 has been abrogated, make a public statement that an excessive deficit in the Member State concerned no longer exists.
	(13) When taking the decisions or recommendations referred to in paragraphs *8 and 12*, the Council shall act on a recommendation from the Commission. When the Council adopts the measures referred to in paragraphs *6 to 8 and 12*, it shall act without taking into account the vote of the member of the Council representing the Member State concerned. A qualified majority of the other members of the Council shall be defined in accordance with Article 238(3)(a).	(13) When taking the decisions or recommendations referred to in paragraphs 8, 9, 11 and 12, the Council shall act on a recommendation from the Commission. When the Council adopts the measures referred to in paragraphs 6 to 9, 11 and 12, it shall act without taking into account the vote of the member of the Council representing the Member State concerned. A qualified majority of the other members of the Council shall be defined in accordance with Article 238(3)(a).
	(14) No amendment.	(14) Further provisions relating to the implementation of the procedure described in this Article are set out in the Protocol on the excessive deficit procedure annexed to the Treaties. The Council shall, acting unanimously in accordance with a special legislative procedure and after consulting the European Parliament and the European Central Bank, adopt the appropriate provisions which shall then replace the

		said Protocol. Subject to the other provisions of this paragraph, the Council shall, on a proposal from the Commission and after consulting the European Parliament, lay down detailed rules and definitions for the application of the provisions of the said Protocol.

5.2 Amendments to the ESM Treaty

In the context of the proposed sovereign default regime, the ESM will, in future, only be able to provide eurozone countries with dedicated loans which have to be used for the recapitalisation of banks. The other means of providing countries with financial aid, which are currently available, must be abolished. In addition, the ESM can already recapitalise affected banks directly, by application of the creditor cascade mechanism under the bank resolution rules and with a significant contribution from the affected Member State. This option should be retained with the additional possibility of the ESM granting credit to the European Bank Resolution Fund of the SRM. For this reason the ESM Treaty must be amended as follows:

	ESM-Treaty	Changes
ESM-Instruments under the ESM-Treaty	Art. 14 current wording	Art. 14
	ESM precautionary financial assistance (1) The Board of Governors may decide to grant precautionary financial assistance in the form of a precautionary conditioned credit line or in the form of an enhanced conditions credit line in accordance with Article 12(1). (…)	To be revoked
	Art. 16 current wording	Art. 16
	ESM loans (1) The Board of Governors may decide to grant financial assistance in the form of a loan to an ESM Member, in accordance with Article 12. (…)	To be revoked

	Art. 17 current wording	Art. 17
	Primary market support facility (1) The Board of Governors may decide to arrange for the purchase of bonds of an ESM Member on the primary market, in accordance with Article 12 and with the objective of maximising the cost efficiency of the financial assistance. (…)	To be revoked
	Art. 18 current wording	Art. 18
	Secondary market support facility (1) The Board of Governors may decide to arrange for operations on the secondary market in relation to the bonds of an ESM Member in accordance with Article 12(1). (…)	To be revoked
ESM-Instruments under the ESM-Guideline on Financial Assistance for Direct Recapitalisation of Institutions	--	*New Art. 1a*
	Currently not considered	***ESM-Loans to the resolution fund*** *At the request of one member state the Board of Governors of the ESM can decide to grant financial assistance to the resolution fund in the form of loans. The resolution fund uses this financial assistance exclusively for the recapitalisation of an institute.*
	Art. 9	*Art. 9*
	Contribution of the ESM Member to the Recapitalisation Operation *[…]*	*To be retained unchanged*
	--	*New Art. 9a*
	Currently not considered	***Contribution of the ESM Member to ESM-loans to the resolution fund*** *The conditions and requirements of art. 9 shall also apply to the instrument of recapitalisation under art. 1a.*

5.3 Amendments to the contractual conditions of government securities

After the debt level of a eurozone country has surpassed the rate of 90% of its GDP, an automatic haircut is to be achieved only if the contractual conditions of government securities as laid out by the Economic and Financial Committee are to be amended as follows:

Consent of creditors not necessary	Amendment	Current Collective Action Clauses by the Economic and Financial Committee (EFC)
	No 2.0	No 2.0
	Does the debt level of a Member State of the euro area reach the reference value of 90% of its GDP, the nominal value of its government securities is to fall by 10% without the consent of creditors. *To Member States of the euro area whose debt level exceeded 75% of GDP by the 1st of January, 2012, the following transitional rule applies:* *Does the debt level of a Member State of the euro area reach a value of 15 percentage points pass the debt level as of the 1st of January 2012 (transitional reference value), the nominal value of its outstanding government securities is to fall by 10% without the consent of creditors. For every year following, the transitional reference value decreases by one percentage point.* *An assessment of whether the reference-or the transitional reference value has been exceeded takes places every year, as soon as data on the debt level and the gross domestic product are available. Data of Eurostat is to be used in the process.*	Not provided.

6 Summary

There are three causes behind the euro crisis: excessive government deficits, different levels of competitiveness in various eurozone countries and the bursting of a credit bubble, after which already faltering states tried to save systemically important financial institutions from default.

The measures taken to prevent future crises – in particular the reforms to the Stability and Growth Pact and the country-specific recommendations, the introduction of macroeconomic surveillance and the Fiscal Compact – cannot prevent future crises.

This is because they ignore a fundamental issue, which is irreparable for the foreseeable future: there is a lack of willingness in all eurozone countries to consistently adjust national fiscal, economic, labour market and social policies to these measures. The European requirements for economic reform and consolidation are being ignored in many countries.

This deficiency ultimately stems from two causes: Firstly, the eurozone countries have not reached a consensus, but openly disagree on what role the market should play as a mechanism for ensuring discipline and coordination. Consequently, the reform requirements are in many cases completely contrary to the economic culture and traditions of the affected country. Secondly, citizens and national politicians feel patronised by requirements set by Brussels and other EU States.

Debt mutualisation and lasting transfer payments between EU States would be liable to encountering partial forceful resistance in the populations of those countries that would be the potential net contributors.

A solution to the eurozone's problems, and its survival, requires that all eurozone countries be once again allowed to make their own decisions regarding timing, type and scope of reforms. This is the only way to ensure that their economic culture and tradition are taken into account and that they do not feel as though they are under external control. However, it must not be possible for fiscal or economic difficulties in one eurozone country to trigger crises in other eurozone countries.

Allowances can be made for the above problems by introducing a sovereign default regime for the eurozone countries. The sovereign default regime must fulfil the following requirements:

(1) The enforcement of sovereign default must be credible.

(2) In the case of a sovereign default, national and international investors and the national voters in their capacity as taxpayers are exclusively liable, and not the taxpayers of other countries.

(3) Every country must be able to control its own fiscal, economic, labour market and social policies.

(4) Any developments that threaten the solvency of a country must become obvious at an early stage so that investors and voter have a chance to respond,

(5) Imbalances in the financial sector must not, in general, threaten sovereign solvency,

(6) financial institutions can cope with the sovereign default.

The elements of a sovereign default regime for the eurozone countries:

The key element: Early, automatic haircut. If the debt level of a eurozone country reaches 90% of GDP (reference value), a haircut of 10% will be triggered automatically. Controlled default with a small haircut will be enforced early on instead of uncontrolled default. This has the following advantages:

(1) Investors can form clear expectations about their risk of loss. Abrupt increases in spreads will give way to a successive rise in spreads if the state in question approaches the reference value. "Panic sales" and “contagion” in other eurozone countries are avoided.

(2) Gradually increasing spreads lead to a slow but constant increase in the pressure for reform. This gives the government time to make corrections. As a result, national politicians are neither misguided by the illusory assurance that reforms are not yet necessary, nor are they suddenly confronted with doubts about their country's debt sustainability obliging them to take hasty countermeasures that in turn precipitate an economic downturn and cause the further erosion of debt sustainability.

(3) If a state approaches the reference value, credit financing becomes more expensive for businesses and consumers, too. They will thus have sufficient time and opportunity, at the latest when it comes to the next election, to inform their politicians of their preferences.

(4) The strong incentives to delay default for as long as possible, thereby raising the default costs, are eliminated.

Transitional arrangements for eurozone countries whose debt level amounted to more than 75% of GDP in 2014. The haircut must be performed where the debt level exceeds the 2014 level by 15 percentage points. This transitional reference value is reduced by one percentage point in each subsequent year, until it reaches the reference value of 90%.

Accompanying measures to prevent new debt via the ECB’s TARGET system. A steady reduction of TARGET imbalances would be advisable. The minimum requirement should be, however, that TARGET claims and liabilities may not increase any further. To achieve this, newly arising account balances would have to be settled once a year by transferring tradeable securities.

Accompanying measures to (partially) shield governments from the default of financial institutions. The resolution provisions passed by the EU are appropriate: The bank resolution costs will now be covered, in the first instance, by owners, creditors, depositors of sums over € 100,000 and the European banks; secondarily by the affected countries; and in an emergency the ESM can grant the country a loan or recapitalise the banks directly. In addition, the ESM should be able to grant a loan to the European Bank Resolution Fund for the recapitalisation of the affected banks.

Shielding financial institutions from sovereign defaults. Government bonds must be covered with equity capital, otherwise the consequences of a sovereign haircut are too drastic and the haircut itself loses its credibility. An upper limit for the volume of government bonds held by a financial institution should be introduced.

Consequences for the existing precautions to safeguard the solvency of eurozone countries. (1)The Stability and Growth Pact is superfluous and can be abolished. (2) The European Stability Mechanism (ESM) will only issue loans for the recapitalisation of banks. The traditional loans to countries, generally used until now to prevent sovereign default, will no longer be possible.

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