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Creating Order in the Euro Zone

Fearing a lasting burden on taxpayers, the German government is preparing a set of insolvency rules for countries in the euro zone. It would require private investors to bear some of the financial burden and force the affected countries to give up some sovereignty. The plan is guaranteed to meet with resistance.

As a physicist and an avowed admirer of the Swabian housewife, German Chancellor Angela Merkel, leader of the center-right Christian Democrats (CDU), is seeking to establish binding rules in the midst of the chaos of financial and monetary crises. Her desire for order was reinforced recently when the prospect of Greece collapsing under a mountain of debt triggered turmoil in the European Monetary Union.

The first national bankruptcy on European soil in decades was only prevented because the remaining countries in the euro zone came to the aid of their faltering fellow member with billions in loans and loan guarantees. The chancellor, determined not to allow the Greek debacle to be repeated elsewhere, proposed the establishment of a procedure to ensure "orderly national bankruptcies." The German chancellor hoped that the plan would create "an important incentive for the euro-zone members to keep their budgets under control."

Finance Minister Wolfgang Schäuble, in complete agreement with Merkel, said: "We have to think about how, in an extreme situation, member states could become insolvent in an orderly fashion without threatening the euro zone as a whole."

Averting Future Problems

The two politicians have taken on a formidable task. They sense that the future of the euro is anything but certain, despite the recently approved €750 billion ($945 billion) European rescue package. In approving the emergency measure, all of those involved, including Merkel, French President Nicolas Sarkozy, European Commission President José Manuel Barroso and Greek Prime Minister Georgios Papandreou, are merely buying time, which they must utilize to work off deficits. This is especially true when it comes to Greece, which will have to restructure its budget by the time all of the bailout packages expire in 2013, but even more so for the euro zone as a whole.

To avert future problems, the Germans have asked their experts to assemble a package of reforms that could stabilize the construct of the European Monetary Union in important ways -- if, that is, the partner countries play along. And even then, it cannot be ruled out that some countries could go bankrupt in the future.

The effort is necessary, because important safety measures to protect the common currency are not working. The Stability and Growth Pact, which was intended to nip excessive government borrowing in the bud, proved to be largely worthless. Some of the monetary union's ironclad principles were ignored, including a rule that prohibits member states from coming to the aid of others in financial difficulties. It was only with political tricks of questionable legitimacy that the euro-zone countries managed to ward off the crisis in the short term, but by no means has it been overcome. German taxpayers, in particular, could face enormous burdens if the current measures fail. Under the provisions of the bailout package, Germany has pledged up to €170 billion.

With her plans for orderly national bankruptcies, Merkel intends to eliminate these vulnerabilities within the monetary union. She hopes to install a procedure under which a bankrupt country could be restructured in the future. She also wants to prevent the rescue program from becoming a permanent fixture in the future and, as a result, a chronic threat to the German federal budget.

Sharing the Burden

Despite the urgency of the problem, the German government must take a cautious approach. The chancellor is worried that her deliberations could be seen as a vote of no confidence in the European bailout package, which is why she is treating the plans with such secrecy. Less than a dozen experts from various parts of the government are even familiar with the matter.

Her goal is to structure the plans as a further development of, rather than an alternative to the bailout package. Work on the project has already made a lot of progress. A concept based on preliminary work carried out by the Finance and Justice Ministries is already being circulated at the Chancellery.

If the plans are implemented, banks and investors will not be the only ones bearing the burden when countries in the euro zone encounter financial difficulties. The debt-ridden countries themselves will also have to make substantial sacrifices, and their governments will cede some of their power. The experts propose a two-step procedure. In describing the goals of this approach, Schäuble says: "Whenever a company files for bankruptcy, the creditors must relinquish a portion of their claims. The same should apply in cases of national bankruptcy."

The reformers expect the plan to have a deterrent effect, both for lenders and borrowers. If banks and private investors must anticipate that they may not recoup all of their investment, they will be more cautious about lending money to certain countries.

Those countries, in turn, will be forced to preserve their credit ratings if they hope to continue borrowing. The goal of the German government experts developing the plan is to straighten out a situation gone haywire in the midst of enthusiasm over the bailout program. "The private sector should be involved in the procedure, so that taxpayers are not the only ones bearing the financial burdens," the plan reads. "The bondholder receives a risk premium through the coupon, so it should also have to bear this risk."

Aggravating the Crisis?

But is this feasible? In a situation in which a euro-zone country can no longer service its debts, the government experts propose a "tailored combination of maturity extension and a suitable reduction of the face value or interest rate" of the bonds in question. In other words, creditors receive less money than they are entitled to, and they have to wait longer for it, a process experts refer to as a "haircut."

The debtor country derives most of the benefit. Its financial burden declines, so that the

government no longer has to incur new debts to pay off the old ones. This reduces the burden on government budgets, because the country can only borrow new funds by offering its lenders a higher risk premium. Because it blasts new holes into the government budget, this crisis surcharge can also aggravate the crisis.

But the creditors should also receive an incentive to accommodate a debtor nation. In return for waiving their claims, they are guaranteed a residual value of the bond, which would be no more than half its face value. The benefit to them is that they do not have to write off the entire bond. The debtor nation must pay a guarantee fee, which means that it also carries a portion of the burden.

Because less than half of debts are usually forgiven in a haircut procedure, the bankrupt countries are left with an "original country risk." This residual amount functions as a signal, because the country's own bonds are still being traded. If this credit rating declines interest rates rise, and if it rises interest rates decline. In other words, investors, governments and bailout organizations are consistently aware of the market's assessment of the situation.

Part 2: Berlin Club as 'International Guarantor'

A newly established Berlin Club would serve as the "international guarantor." The German government experts see this organization as an "apolitical and legally independent entity."

The plans build on existing institutions involved in international debt settlement. While the Paris Club regulates debt restructuring among nations, the London Club specializes in liabilities between banks and countries.

The German government hopes to bridge a gap with its proposal. The Berlin Club would concentrate on government bonds and the associated derivative securities. The members of the club could be recruited from within the G-20 group of industrial and emerging nations. Another possibility would be to establish the club within the framework of the euro zone.

The International Monetary Fund (IMF) would be involved in the debt refinancing from the

outset. The German experts see the IMF playing a key role. If representatives of the Washington-based organization determine that debt forgiveness and restructuring have failed, then the second phase of the procedure kicks in.

It amounts to a complete refinancing. According to the concept, "this will require restrictions on sovereign discretionary powers." In other words, the government of the affected country would no longer be able to fully dispose of its own treasury.

Institutionalized Disempowerment

It would be replaced with "an individual or group of individuals familiar with the regional characteristics of the debtor nation," which would safeguard the financial interests of the bankrupt country. The Berlin Club would have the authority to appoint these individuals.

The concept toughens the stance, particularly toward creditors, but also toward the debt-ridden country. If it is implemented, it will amount to an institutionalized disempowerment of a debtor nation's government by the IMF and the new Berlin Club, at least in its final stage. This prospect alone could have a disciplining effect on overspending governments.

But the concepts would also represent an imposition on international donors. Until now, conventional bailout programs like the one devised for Greece have been based primarily on the notion that a cash-strapped government receives public funds from other countries, while private donors are not asked to waive their claims. To put it simply, taxpayers in countries with reasonably healthy government finances, particularly Germany, have taken the place of banks and private investors that have extricated themselves from ailing economies. This would no longer be the case in the future.

This is also the way the EU's and IMF's €750 billion rescue package works. The bailout funds provide the euro zone with planning security until 2013, but it is by no means certain that the crisis will have been resolved by then. Experts predict that by that time Greece will be burdened by a debt ratio of 150 percent of its gross domestic product. The country will have an enormous need for fresh loans, but the difficulties it faces in getting those loans will probably be just as great. This suggests that the country could quite possibly stumble from one bailout program to the next.

Resistance Guaranteed

It is also completely unclear as to if, when and to what extent the new concept could even be implemented. Regardless of whether the government introduces its plans at the G-20 level or within the task force headed by European Council President Herman Van Rompuy, resistance is guaranteed.

Countries immediately or potentially threatened by insolvency, like Greece, Portugal and Spain, will be up in arms against the proposals from Berlin. Why should they agree to rules that would make it easier for the remaining euro countries to deny them aid in an emergency?

But the German government is determined not to be the paymaster for Europe's debt transgressors in the long term. Officials at the Chancellery and Finance Ministry fear that otherwise the German public's support for the euro and the EU would be undermined.

In developing their scenarios, the government experts assume that other potential donor countries share their concerns. The governments of France, Finland and the Netherlands are likely to be just as interested in private creditors and debtor nations bearing a portion of the burden.

No Way Around Emergency Planning

The concept by no means sells itself. If the project were organized under the auspices of the EU, it would face a high hurdle: The European treaties would have to be amended to establish the Berlin Club, which would require the consent of each individual member. This is not a process governments are keen to repeat after the experiences of the Lisbon Treaty.

Nevertheless, there is no way around pushing ahead with emergency planning, because the situation could come to a head more quickly than anticipated. The aid for Greece is subject to the Papandreou government fulfilling the EU and IMF requirements. The Greek prime minister

is full of good intentions, but his measures have been relatively ineffective so far. Although the government is raising taxes and even introducing new taxes, revenues have fallen short of expectations. Strikes, like the one that was staged last Thursday, are constantly paralyzing public life and the economy.

In other words, it is quite possible that Greece will not fulfill the conditions and thus will receive no aid from the European fund. This could lead to a consequence that European leaders have been trying to prevent at all costs: a total national bankruptcy. And, if the reform package has not been implemented by then, it could end up being anything but an orderly process.

Translated from the German by Christopher Sultan

http://www.spiegel.de/international/europe/0,1518,705959,00.html