Forthcoming Bruegel Policy Brief No 2011/02, February 2011

A comprehensive approach to the euro-area debt crisis

***Zsolt Darvas, Jean Pisani-Ferry and André Sapir*[1]**

1. Introduction

More than a year after it started in Greece and later on spread to three other peripheral countries, Ireland, Portugal and Spain[2], the sovereign debt crisis in the euro area still goes on. True, significant steps have been taken to resolve the predicament. Crisis mechanisms have been set up by the EU (the European Financial Stability Mechanism - EFSM) and by the euro area (the European Financial Stability Facility - EFSF), and financial assistance has been provided to Greece and Ireland. Governments in these and other affected countries have implemented severe austerity measures and started to put in place structural reform programmes. And the European Central Bank (ECB) has embarked on a (controversial) peripheral sovereign debt purchase programme, while continuing its earlier support to euro-area banks with ample liquidity provision.

But these measures have not been sufficient to restore calm in markets. In early February 2011, spreads on 10-year government bonds issued by Greece, Ireland, Portugal and Spain are all higher than they were in April 2010, before rescue measures started to be implemented.

There are three reasons why European policies have been insufficient to solve the problem:

- First, they have failed to recognise the possibility of insolvency and have addressed all crises as if they were purely liquidity crises.
- Second, they have failed to address in a systemic way the interdependence between banking and sovereign crises and the interdependence across countries.
- Third, they have been mostly reactive rather than proactive, thereby squandering their initially strong credibility by a series of partial, inadequate and belated responses.

[1] We are grateful to colleagues within and outside Bruegel for comments on earlier versions of this paper and to Christophe Gouardo for excellent research assistance.

[2] Our criterion for focusing on these countries is the level of interest-rate spreads on long-term government bonds. We could have spoken of "high-spread countries".

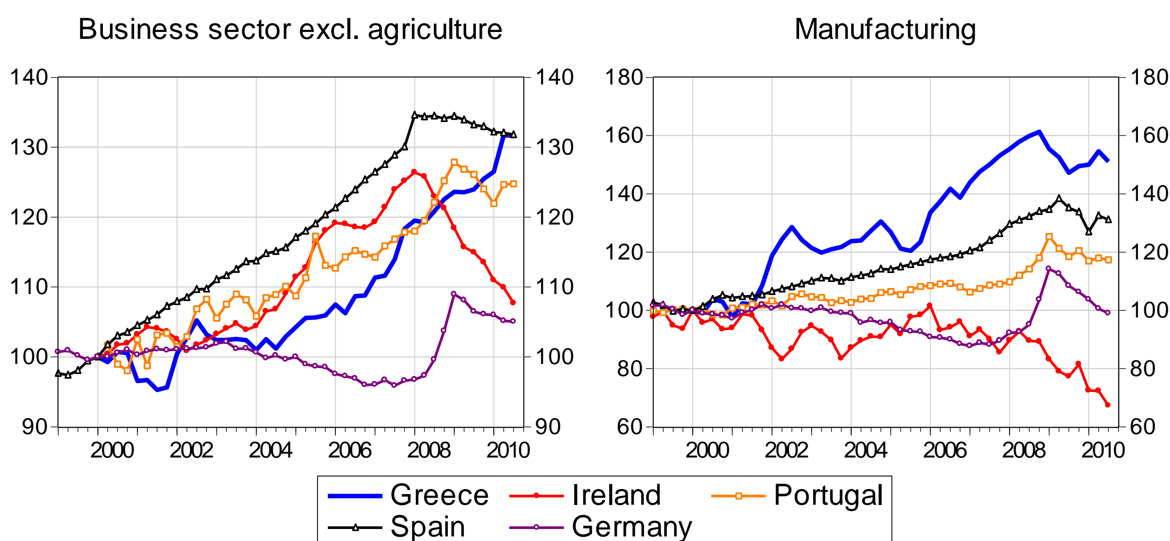
To restore market stability and regain credibility a swift, radical and comprehensive solution is now needed. Such a strategy must comprise of three components: fostering adjustment and growth by promoting budgetary consolidation and competitiveness-enhancing domestic reforms in peripheral countries; restructuring of public debt where needed; and restructuring of banks where needed. The purpose of this paper is to outline what this strategy could be.

2. The sovereign debt nexus

In many ways the four peripheral countries share common traits. Since the run-up to the euro and especially after joining the euro area, they have spent and lived beyond their means by accumulating private and/or public debt and running large current account deficits. Nominal wages have also grown significantly more than justified by productivity performance, resulting in prices growing too fast in comparison to the rest of the euro area (Figure 1). In some cases (Ireland) price divergence essentially took place in the non-traded sector – especially construction and services – whereas in other countries the traded sector – especially manufacturing – was also affected. Such behaviours, and the policies that made them possible, were fundamentally incoherent with participation in the single European currency.

In the last two years adjustment has started in all these countries and major policy measures have been taken in the course of 2010. Results are already visible in Ireland.

Figure 1. Unit labour cost developments 1999Q1-2010Q3 (2000Q1=100)



Source: Bruegel calculations with OECD data

As argued by Marzinotto, Pisani-Ferry and Sapir (2010), however, the Greek crisis stands apart from the crises in the other peripheral countries. First, the Greek public debt predicament originates mainly in the mismanagement of public finances, while problems with banks have played a secondary role only. Second, with a debt-to-GDP ratio scheduled to reach 150 % in 2011 and to continue rising in subsequent years, the country is clearly on the verge of insolvency. By contrast, in Spain and Ireland, a major reason for solvency concerns arises from the public finance consequences of private-sector debt accumulation, not least because of the cost of rescuing insolvent banks. Furthermore, public debt levels in these two countries and in Portugal are more manageable (with levels in 2011 remaining below 70, 90 and 110 % of GDP, respectively, in Spain, Portugal and Ireland) than in Greece.

This assessment is confirmed by a forward-looking evaluation of the public debt situation in the four countries (Box 1). Under Consensus Economics forecasts as regards nominal GDP growth and an optimistic evolution of market interest rates (in the case of Greece, a reduction of spreads vis-à-vis Germany from 970 basis points today to 350 in 2014), the adjustment needs are of frightening magnitude, not only in Greece but also in Ireland. This is even truer under more cautious assumptions for growth and interest rates (Figure 2).

Box 1: Sustainability assessment

In order to assess fiscal sustainability, we examine two scenarios:

- **Optimistic scenario**:
  - Interest rate spreads against German Bunds are optimistically assumed to fall from the current high levels to 350 bps in Greece, 200 bps in Ireland, 150 bps in Portugal and 100 bps in Spain by 2014 and are assumed to stay at these levels.
  - GDP growth assumptions are derived on the basis of Consensus Economic forecasts;
- **Cautious scenario**:
  - Interest rate spreads against Germany do not fall as much as assumed in the optimistic scenario (we use the expectation hypothesis of the term structure to estimate the expected future interest rates).
  - Especially in the case of Greece, Portugal and Spain, where the business climate is weak and where we see serious competitiveness problems, efforts to regain competitiveness are assumed to impact growth and inflation negatively compared to the previous scenario (Table B1);

In both scenarios we use estimates from Barclays Capital on potential additional bank recapitalisation by governments. For Ireland and Spain we use their high-risk estimate, but for Greece and Portugal we use the benchmark as Barclays does not report high-risk estimates for these countries. The corresponding public finance cost amounts to € 10 bn in Greece, € 31.5 bn in Ireland, € 10 bn in Portugal and € 75 bn in Spain. We take into account the fact that the Irish government has put aside € 17.5 billion from its cash reserves and liquid assets to support banks. The Spanish value does not include support already provided by the government. We do not assume any privatisation revenue in order to remain on the conservative side.

The primary balance (in percentage of GDP) in Greece and Ireland is assumed to evolve according to the EU-IMF programme assumptions as indicated in the IMF country reports published in December 2010. For Portugal and Spain we use the November 2010 forecast of the European Commission up to 2012, and assume that the primary balance will improve by 1.5 percentage point of GDP both in 2013 and 2014.

With the above assumptions, we calculated the persistent primary balance needed from 2015 onwards in order to (a) stabilise the debt/GDP ratio at its 2015 level, (b) reduce the debt/GDP ratio from its simulated 2014 level to 60 percent of GDP (the Maastricht criterion) by 2034.

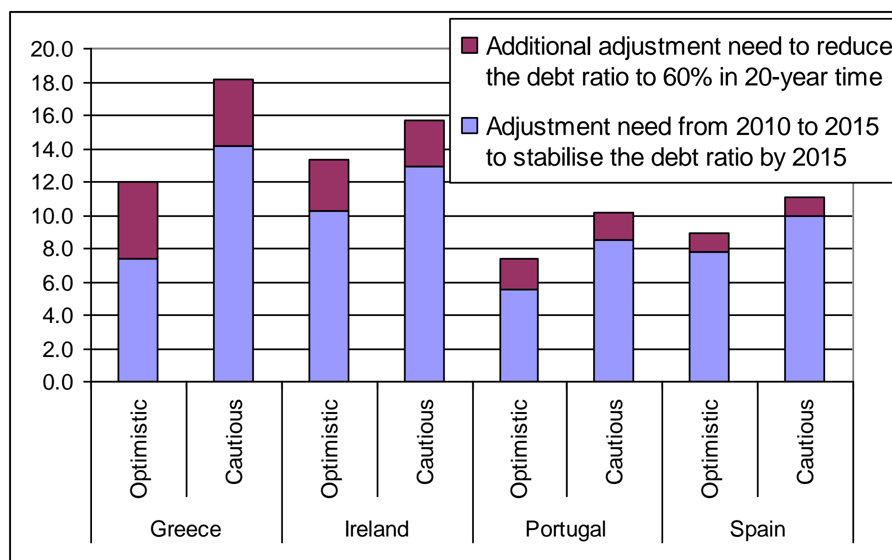
Darvas, Gouardo, Pisani-Ferry and Sapir (2011) present the detailed assumptions and calculations.

Table B1. GDP growth assumptions for the sustainability analysis

		2011-15			2016-20		
	scenario	Real GDP gorwth	GDP deflator	Nominal GDP growth	Real GDP gorwth	GDP deflator	Nominal GDP growth
Greece	**Optimistic**	0.8	0.9	1.6	2.3	2.0	4.3
	Cautious	0.1	0.8	1.1	1.0	1.0	2.0
Ireland	**Optimistic**	2.4	1.4	3.8	2.9	1.9	4.8
	Cautious	2.0	1.1	3.2	2.5	1.5	4.0
Portugal	**Optimistic**	1.2	1.4	2.5	1.9	1.9	3.8
	Cautious	0.6	1.0	1.6	1.0	1.0	2.0
Spain	**Optimistic**	1.4	1.5	3.0	2.0	1.8	3.8
	Cautious	0.9	1.0	1.9	1.0	1.0	2.0

Source: Consensus Economics and Bruegel assumptions

Figure 2. Primary balance adjustment needs between 2010 and 2015 (% GDP) under different macroeconomic scenarios and different debt stabilization objectives



Source: Bruegel.

Note: the 2010 primary balances were -3.7% in Greece, -9.6% in Ireland (excluding bank support), -4.4% in Portugal and -7.3% in Spain. The stabilised levels of debts in the case of the adjustment indicated by the blue part of the bars are the following: 160% in Greece, 123% in Ireland, 98% in Portugal and 84% in Spain.

It is not only the size of the adjustment effort that matters. The key indicator for assessing solvency is the size of the primary budget surplus that needs to be maintained over a period of years to achieve, in the medium term, a gradual return of the public debt to safe levels. Here the numbers for Greece stand apart from those for other countries. Even under the optimistic scenario, the primary surplus required to reduce the debt ratio to 60 per cent of GDP in twenty years would be 8.4 per cent of GDP. It would reach 14.5 per cent of GDP under the cautious scenario. This would imply devoting between one-fifth and one-third of tax revenues to interest payments on the public debt. Over the last 50 years, no country in the OECD (except Norway, thanks to oil surpluses) has ever sustained a primary surplus above 6 per cent of GDP. Even less ambitious targets would require politically unrealistic surpluses.[3]

Our conclusion therefore is that Greece has become insolvent and that further lending without a significant enough debt reduction is not a viable strategy. This conclusion does not apply to Ireland which also needs to carry out a major budgetary adjustment but where the primary surplus required to keep the debt ratio at sustainable level remains within the range of what has been achieved in historical experience.[4]

So far, however, the possibility of restructuring the Greek sovereign debt has been met with complete opposition on the part of euro area countries. The main argument seems to be that it could create a contagion effect throughout the area since much of the Greek debt is held outside the country but within the euro area. The concern is mainly about banks in core euro area countries (mainly France and Germany) that invested heavily in higher-yielding peripheral bonds.

Preference for postponement is also likely supported by a 'wait and see' attitude: On the one hand, it is hoped that Greek reforms will transform the economy, putting it on a faster-track

[3] As in many countries the Greek state has assets as well as liabilities, including significant holdings of land. These could potentially serve as collateral to guarantee loans but even a major divestiture of public property would be insufficient to modify the conclusion.

[4] Considering the status quo, e.g. current official lending rates to Ireland, 3.7 percent persistent primary surplus would be needed from 2015 in the optimistic scenario and 6.1 percent in the cautious scenario to reduce the debt ratio to 60 percent from 2014 to 2034, according to our calculations. See Table 1 for the impact of possible policies and a fall in market interest rates on these results.

growth path, thereby alleviating the public finance situation; on the other hand, it is hoped that time would help weaker banks in the euro area to restore solvency, and make them better able to weather restructuring at a later point in time.

History suggests, however, that such a 'wait and see' approach is a dubious strategy. Although clearly desirable, reforms and growth acceleration are hard and time-consuming processes. And the lingering threat of restructuring is likely to be economically and financially damaging for the economy. Moreover, as official creditors - EU partners and the International Monetary Fund (IMF) - are gradually substituting private creditors to Greece, postponing the restructuring would imply, to keep the debt ratio at sustainable levels, either a restructuring of official loans, or a significantly higher eventual haircut on private claims.

3. Assessing the soft options

To be fair, the official EU community has moved away from complete denial about the Greek debt situation and is now looking for a middle way between adjustment only and debt restructuring. In Table 1, we provide for all four peripheral countries an assessment of what might be the effects of three types of measures that are currently considered:

- A lowering of the interest rate charged on all types of official EU loans (IMF rates cannot be lowered) to 3.5 per cent annually;
- An extension of the maturity of all types of official EU loans to 30 years, and the transformation of the current Greek IMF Stand-by Agreement into an Extended Fund Facility (which would extend the repayment date from 2018 to 2023, as in Ireland);
- The purchase by the EFSF of all government bonds currently held by the ECB within the framework of its Securities Market Programme and the retrocession of the corresponding haircut to the issuing country.[5]

In addition we provide an evaluation of what might be the effect of these measures on market sentiment in terms of lower yields, with a drop by 100 basis points.[6]

[5] We only consider here buy-backs from the ECB, which is feasible without any market interference. We discuss the scope for further buy-backs from the market in the next section. Note also that as the current market value of ECB holdings is close to their value at the time of purchase, we consider this retrocession to be broadly neutral for the profit-and-loss account of the ECB.

[6] Obviously calculations only apply to measures that are currently applicable. For example, we only consider maturity extension for the countries (Greece and Ireland) that benefit from financial assistance, and for Portugal we only consider the buy-back of current ECB bond holdings from a 30-year 3.5 percent loan.

Table 1: Assessment of alternative policies

		Persistent primary surplus needed from 2015 onwards in order to stabilise the debt/GDP ratio at its 2015 level (% of GDP)				Persistent primary surplus needed from 2015 onwards in order to reduce the debt/GDP ratio from its simulated 2014 level to 60 percent of GDP by 2034 (% of GDP)			
		(a)	(b)	(c)	(d)	(a)	(b)	(c)	(d)
			Deviation from baseline				Deviation from baseline		
	scenario	Baseline	Three policies	100 bps lower market yields	Three policies + market reaction	Baseline	Three policies	100 bps lower market yields	Three policies + market reaction
Greece	Optimistic	3.7	-1.3	-1.0	-2.1	8.4	-1.8	-0.8	-2.4
	Cautious	10.5	-2.7	-1.0	-3.4	14.5	-3.0	-0.9	-3.6
Ireland	Optimistic	0.7	-0.5	-0.6	-1.0	3.7	-0.8	-0.4	-1.1
	Cautious	3.3	-0.8	-0.5	-1.2	6.1	-0.9	-0.4	-1.3
Portugal	Optimistic	1.2	-0.1	-0.7	-0.7	2.9	-0.1	-0.6	-0.8
	Cautious	4.1	-0.1	-0.7	-0.8	5.8	-0.1	-0.7	-0.8
Spain	Optimistic	0.5		-0.6		1.6		-0.6	
	Cautious	2.7		-0.7		3.8		-0.7	

Source: Bruegel simulations.

Note: Column (d) is not the sum of columns (b) and (c) because the marginal impact of policy measures is smaller when market interest rates are lower.

Each of these three measures would clearly help reduce Greece's debt burden both directly and indirectly via lower market interest rates. However, our calculations indicate that even if they were all applied together these measures would still be insufficient to return the country to solvency, since they would still leave it with an unrealistically high primary budget surplus requirement.

Furthermore, the current stance of 'no default now, but possible default on bonds issued from 2013' is inconsistent and therefore not credible. Up to 2012, markets will price in the default option, making it difficult for troubled governments to borrow. From 2013 on, if the stance is indeed maintained, the Greek government will not be able to issue bonds. However, a second official lending programme for Greece in 2013 would likely find even more political resistance from euro-area partners and would further increase the share of official creditors in Greek debt.

We therefore consider that a debt reduction is necessary for Greece. On the basis of our scenarios we estimate that to return to a sustainable path and reach a 60 per cent debt-to-GDP ratio in twenty years, Greece would need (in addition to the three measures of Table 1) a 30 per cent haircut to the marketable public debt.[7]

[7] This assumes that assistance loans will be exempt from restructuring and that market reaction to the debt reduction will result in a drop of the spread vis-à-vis Germany to 200 basis points. Under these conditions, from

4. Assessing potential spillovers

The main roadblock to a rapid resolution of the euro area crisis is the difficulty for policy makers to tackle the spillover effects both between banking and sovereign difficulties and across countries in the absence of any European sovereign debt and banking crisis resolution mechanisms.

In order to assess the task at hand, we start from a simplified map of interdependence between banks and sovereigns in the periphery countries, and between periphery banks and those in the rest of the euro area (Frontpage Figure and Table 2). Although drawing up such a map involves a number of assumptions[8], our sense is that it provides a reasonably accurate representation of the actual situation.

Table 2. Estimated exposure to periphery government debt and banking system (€ bn), end-2010

	Greece	Ireland	Portugal	Spain	Total
Total government debt (at face value)	**325**	**153**	**142**	**677**	**1297**
of which held by :					
Domestic banks (1)	68	11	19	227	336
Euro-area banks	52	14	33	79	166
Other banks (1)	6	9	5	24	43
Non-banks (both residents and non-residents) (2)	119	97	64	347	627
ECB	50	22	21	0	93
IMF, EU and official lenders	32	0	0	0	32
Ratio of average market value to face value of government debt (3)	0.75	0.85	0.90	1.00	
Foreign banks' exposure to national banking systems (4)	10	119	43	209	381
of which euro-area banks	6	66	37	154	264
Eurosystem lending to banks through the national central bank (5)	95	132	41	65	333

Sources: Bruegel calculations and estimates using data from BIS, IMF, World Bank, Eurostat, Eurosystem, CEBS, Datastream, National Sources, Barclays Capital, Citigroup.

Note.

(1) For The total is not equal to the sum of the columns as intra-country exposures are netted out

(2) Non-Banks is calculated as the unidentified portion of government debt (financial institutions not classified as banks are included in this category)

2015 a 6.0 percent persistent primary surplus (the programme assumption) is needed in our cautious scenario, while a 3.6 percent surplus in the optimistic scenario, to reach the 60 percent debt ratio by 2034.

[8] See Darvas, Gouardo, Pisani-Ferry and Sapir (2011) for details.

(3) Average weighted discount based on clean price of fixed-rate, non zero-coupon bonds. Note that bonds of some of these countries were traded above face value before the crisis and therefore the fall in market price does not equal the current discount. For example, most Spanish bonds were also traded above face value, while currently some of the bonds are still priced above while the other bonds are priced below, leading to a close to face value average.

(4) As of June 2010; the total also includes intra-country exposures

(5) "Lending to euro area credit institutions relating to monetary policy operations" by the national central banks; it is reasonably to assume that they exclusively lend to domestic institutions. December 2010 for Ireland and Portugal; November 2010 for Greece and Spain.

Starting with Greece, our estimates indicate that the spillover effect from a sustainability-restoring haircut on sovereign debt would result in a manageable impact on banks in the rest of the euro area. Some of them would no doubt be in need for recapitalization but even assuming this recapitalisation would be entirely borne by the public purse (a disputable choice and therefore an extreme assumption), the impact on the public finances of the partner euro area countries would remain limited. Therefore, the fear of domino effect is understandable, but excessive.

What Table 2 also shows is that spillover effects from crises in other countries are clearly different. The exposure of euro-area banks to Irish sovereign risk is unimportant and it is really exposure to banks that matters. Exposure to Portugal is limited. Only Spain is really systemic, through both the sovereign and the banking channels.

5. A comprehensive solution

We see a comprehensive solution to the current crisis as consisting in three planks:

- A method to reduce the Greek public debt;
- A plan to restore banking sector soundness;
- A strategy to foster growth and competitiveness.

Reducing the Greek debt

The calculations presented in sections 2 and 3 imply that it would be preferable to implement sooner, rather than later, a significant reduction of the Greek debt.

It would clearly be less disruptive financially, and therefore preferable, to achieve a reduction in the debt level through voluntary exchanges than through an outright, across-the-board debt restructuring. This justifies giving the EFSF the mission and the financial means to carry out such operations on a significant scale. This decision should be taken by heads of state or government of the euro area on the occasion of the March European Council, as part of the overall package

under consideration, and the EFSF should immediately buy from the ECB debt securities purchased within the framework of the Sovereign Market Programme.

A debt exchange however is not without problems. In particular, a voluntary exchange will only be marginally effective as long as the EU sticks to its no-restructuring commitment, because, if credible, this commitment acts as an incentive to hold rather than sell the asset. In order to make debt-exchange schemes effective, public authorities would need to convey to markets their determination to reach, one way or another, a reduction of public debt to a level compatible with sustainability. This requires on their part recognition of the unsustainable character of the present policy course and a joint evaluation by the Commission, the ECB and the IMF of the required amount of debt reduction.

Restructuring would not be an easy option either, both because of its impact on financial institutions that have not marked debt securities to market (which is the case of many banks) and because of the seniority issue. Currently, bilateral government loans and EFSF loans do not enjoy formal seniority status. Yet it would be unthinkable to bail-in those EU members who came to the rescue of their ailing partners, especially since the IMF, which provided parallel loans, enjoys senior creditor status. If a formal restructuring is needed, we advocate to organise it taking inspiration from the mechanism presented in Gianviti et al. (2010).

In both cases, the burden of adjustment should not fall on private bondholders only. First, consistent with international experience, investors should be offered a variety of new, guaranteed instruments as developed in Delpla and von Weizsäcker (2011); second, they should be given an opportunity to benefit from an upside in economic conditions through, e.g., GDP-indexed bonds; third, Greece should be requested to post collateral to guarantee the new debt instruments.

Furthermore, Greece and Ireland currently benefit from loans from the EU member states or the EFSM/EFSF at relatively high interest rates compared to rates at which these countries or institutions are able to borrow on markets. This was intended to signal that these loans should not be regarded as concessional, partly in response to fear of recourse to the German constitutional court for breach of the no bail-out clause. However, high interest rates have caused political tensions in the borrowing countries and reduced the domestic ownership of the programmes. They have also weakened the credibility of these programmes as they aggravate somewhat the sustainability problem the countries are facing. Interest rates on official loans should be reduced at levels corresponding to the borrowing cost of the lender, plus an operational margin, in line with EU assistance to Hungary, Latvia and Romania. The experience of Hungary suggests that countries may be willing not to draw the full amount of the

preferential rate assistance when reasonable market borrowing conditions are restored, in order to boost market confidence.[9]

Strengthening the euro-area banking system

Assumptions made in our calculations are deliberately cautious. As already indicated, we have assumed further banks losses and recapitalisation needs of an order of magnitude corresponding to adverse-case market forecasts. Even under this assumption, we assess the spillover risks to be manageable and conclude that only Greece is in need for a debt reduction. We are aware however that our information is incomplete.

Our estimates of financial interdependence in the euro area show the exposure of peripheral banks to peripheral sovereigns and of non-peripheral banks to both peripheral banks and sovereigns. What is missing however from our mapping is the exposure of peripheral banks to potentially non-performing loans and the resulting risk for banks in the rest of the euro area as well as for sovereigns in both peripheral and non-peripheral countries should banks need to be recapitalized with public funds. This crucial missing link was supposed to have been filled by the European stress test published last July. Unfortunately it was totally discredited by subsequent developments in Irish banks and markets have been concerned ever since that the current and future situation of banks in the euro area may be far worse than currently admitted.

The implementation of rigorous and credible stress tests is therefore an absolute priority for the euro area. As EU banking supervisors have squandered credibility in the previous round of stress tests, we advocate involving the IMF and possibly the BIS in the certification of the next round of tests. We suggest that the March European Council adopts the necessary measures to ensure that the forthcoming stress test be as rigorous and credible as possible.

Once such tests have been carried out, euro area countries, not only in the periphery but also in the core, must proceed immediately with the restructuring of their banks where necessary, which should imply the recapitalization of viable institutions and the closure of nonviable ones. To this end, EFSF funding should be made available to governments if necessary.

The need to restructure some banks in core countries is likely to be necessary especially if bank losses turn out to be fairly large in Spain, the only peripheral countries where restructuring would, according to our estimates, have a significant spillover effect on the rest of the euro area.

[9] The Hungarian government launched a 5-year euro denominated bond with a coupon of 6.75 percent in July 2009 instead of drawing from the approximately 3.2 percent interest-rate EU financial facility. Following the success of this issuance it has not drawn anything from the remaining portion of the assistance programmes.

Bank restructuring would be greatly accelerated and helped if EU countries introduced special bank resolution mechanisms in their domestic legislation in line with recent Commission proposals. In line with the German proposal for a Competitiveness Pact of February 2011, we advocate that heads of state or government agree in March to put in place such mechanisms without delay.

Beyond the immediate short term, there is an obvious need to put in place a solid European framework for banking supervision and resolution. One of the lessons from the crisis is that such framework needs to go beyond the coordination between national institutions. Nothing short of supra-national bodies in charge of banking supervision and resolution are capable of handling the kind of financial interdependence that now exists in Europe. Ideally, such bodies should cover all EU countries since they all belong to a single financial market. However, in case this proves to be politically unfeasible, euro area countries should go ahead and create their own bodies.

Prior to the crisis, the creation of EU- or euro-area-wide institutions in charge of banking supervision and resolution was considered unacceptable by European countries because it would amount to the pooling of risks associated with bank failures. What the crisis has shown is that the absence of such institutions imposes an even bigger burden sharing on countries, especially within the euro area where the ECB has been made to act as the lender of last resort to banks that may turn out to be insolvent.

Fostering growth in the peripheral countries

Given the size of public and private debts in the peripheral countries, regaining sustainability will require a combination of lower living standards and higher production levels, especially in the tradable sector. To this end economic policy should be geared, first and foremost, toward implementing domestic reforms aimed at increasing employment and productivity. However, even if successful, such reforms will take time to produce their effects. In the meantime, growth will remain subdued and even if reduced, debt will stay at high levels. Efforts by the private and the public sectors to pay up their debts will have a negative impact on growth, and low growth will it make more difficult to reduce debt levels. These countries are also confronted with the risk of debt deflation as restoring competitiveness in the tradable sector will require low price increases and perhaps even deflation.

In order to break up this vicious circle, peripheral countries need to first stabilize and then reduce their debt levels while accelerating the pace of economic reform. But the EU can and should play an important role in helping these countries find the narrow policy path to extricate

themselves from their debt problems by contributing to foster reforms and growth in these countries.

We have already emphasised the potential role of better terms for conditional financial assistance and the implementation of comprehensive measures to exit the debt deadlock. Currently, private investment is withheld and public borrowing costs are heightened due to lingering uncertainty about banking sector resolution and sovereign defaults.

But the EU should also do more with the instruments at its disposal. We strongly advocate a temporary refocusing of the structural funds earmarked for spending in the peripheral countries, so that money can be mobilized to support a new growth strategy. As argued in Marzinotto (2011), this requires front-loading EU structural spending (without changing its distribution by country), so that it can contribute to fostering reform and growth during the most acute phase of the adjustment. This also requires a joined, coordinated approach, including with the EU-IMF programme, instead of the current silo approach that hinders coherence and effectiveness. We suggest the European Council in March adopts a programme along these lines as part of its Pact for Competitiveness.

In the longer term the EU can also help through making better use of its budget. The discussion on the next 2013-2020 financial perspectives is an opportunity for fresh thinking about new ways to foster investment in our four countries and other crisis-affected countries, especially in Central and Eastern Europe.

6. Conclusion

For several weeks there has been expectation among political observers and market participants that the March European Council will deliver measures amounting to a comprehensive solution to the euro-area crisis. Such expectation was reinforced by the conclusions of the European Council on 4 February 2011, where heads of state or government of the euro area announced their intention to finalize in March a "comprehensive strategy to preserve financial stability".

We have argued that a comprehensive approach to solving the crisis must start by recognizing two basic facts. The first is that peripheral countries face a huge challenge in having to adjust their weak economies so as to avoid a vicious circle of high private and public debts on the one hand and low growth on the other. The second is the interdependence between banks and sovereigns not only within peripheral countries but also between these countries and the rest of the euro area.

Based on these two facts, which we document with novel estimates and analyses, we propose a comprehensive strategy comprising of three components. The first is the reduction of the public debt in Greece, the only euro area country which has become insolvent. The second component consists in the cleaning up of banks, wherever needed and simultaneously throughout the euro area, based on the results of a rigorous stress test given added credibility by the involvement of the IMF. The third component involves fostering adjustment and growth in peripheral countries not only through budgetary consolidation and competitiveness-enhancing measures in these countries but also through the mobilization and better implementation of EU structural funds.

Too much time has been lost, too much confidence has been dented and too much credibility has been squandered in the past year. Building on important decisions already reached, EU leaders should move decisively and agree on a comprehensive package along the lines suggested here at their forthcoming March summit. This would be a major contribution to the cohesiveness and the revival of the euro area.

References

Delpla, Jacques, and Jakob von Weizsäcker (2011), “The Blue and Red Bond Solution”, Bruegel, forthcoming, February.

Darvas, Zsolt, Christophe Gouardo, Jean Pisani-Ferry, and André Sapir (2011), “A Comprehensive Approach to the Euro-Area Debt Crisis: Background Estimates”, Bruegel, forthcoming, February.

Gianviti, François, Anne Krueger, Jean Pisani-Ferry, André Sapir, and Jürgen von Hagen (2010), “A European Mechanism for Sovereign Debt Crisis Resolution: A Proposal”, Bruegel Blueprint No. 10.

Marzinotto, Benedicta (2011), “A European Fund for Economic Revival in Crisis Countries”, Bruegel, forthcoming, February.

Marzinotto, Benedicta, Jean Pisani-Ferry, and André Sapir (2010), “Two Crises, Two Responses”, Bruegel Policy Brief No. 2010/1.