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# AN ACTION PLAN FOR EUROPE'S LEADERS

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## Highlights

- At the extraordinary European Council of 21 July European leaders should first pave the way to restoring solvency in Greece by initiating debt reduction. This implies: i) reducing the interest rate on official lending, ii) requesting from the European Financial Stability Facility (EFSF) support for an immediate bond buy-back programme, and iii) asking the European Systemic Risk Board (ESRB) for an immediate evaluation of the risks to financial stability involved in a future restructuring of sovereign debt in the euro area.
- Second, immediate growth-enhancing measures should be financed through unused European Union Structural Funds and European Investment Bank loans (€16 billion), which should be used to: i) raise the quality of higher education, ii) finance wage subsidies in manufacturing and tourism to generate an internal devaluation while containing domestic-demand costs; and iii) create research laboratories to underpin an upgrading of Greece's value chain.
- Third, risks to financial stability in the euro area should be addressed by breaking the vicious circle of sovereign debt and banking risk. The EFSF should be able to guarantee national deposit insurance schemes; at the same time, the European Banking Authority should assume stronger supervisory powers.
- This is an immediate action plan. More ambitious reform should follow.

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# AN ACTION PLAN FOR EUROPE'S LEADERS

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THE GREEK CRISIS is only one aspect of a broader set of issues that the leaders of the euro area need to address urgently to stop the escalation of market turbulence. But Greece has become, in the eyes of market participants and citizens, the litmus test of the EU's ability to solve its problems. By acting effectively over Greece, the euro area would demonstrate that it can address the problems assailing Europe.

The extraordinary meeting of European leaders on 21 July should map out the EU's strategy for responding to this crisis, starting with the restoration of Greece's solvency. The response to immediate concerns about sovereign debt must be combined with a credible growth strategy. Finally, leaders should address broader systemic euro-area fragilities.

## 1 PAVE THE WAY TOWARDS RESTORING GREEK SOLVENCY

Greece is insolvent. Any policy measure needs to start from the fact that under plausible economic, financial and political assumptions it will be impossible for the Greek government to generate and sustain the primary budget surplus necessary to achieve solvency. It would be irresponsible to assume that Greece could generate such a huge surplus, as this eventuality rests on a series of low-probability developments[1]. Generating a surplus would be difficult for any country grappling with excessive debt, but is even more so for a country that is unable to use the exchange rate as a policy tool because it is member of a monetary union, and has to undergo an internal devaluation to restore competitiveness and foster sustainable growth.

We estimate that a viable solution to deal with Greece should result in reducing the net present value (NPV) of future debt obligations by at least a third.

Though European leaders should recognise this reality, they, the European institutions and financial markets remain unprepared for a significant debt restructuring at the expense of private investors. Preparatory work to ensure the recapitalisation of banks heavily exposed to sovereign risk – first and foremost the Greek banks – and for mitigating threats to financial stability is in its infancy. While more informative and credible than those conducted a year ago, the European Banking Authority's recent stress tests have not helped in this regard because the possibility of sovereign default has not been considered. Moreover, a restructuring at this stage, especially if hastily prepared, could lead to further increases in spreads in other euro-area countries. Finally, the European Central Bank remains adamantly opposed to debt restructuring and it is threatening to cut off the Greek banking system from access to liquidity.

After the trauma of the global financial crisis, and with some banks in a still-precarious state, it is crucial for the euro area to avoid a precipitous and disorderly default. European leaders have no choice but to postpone the eventual launch of a restructuring process. This would also give time to enact much-needed reforms in other countries. For example, the Spanish government has committed to the consolidation of its savings banks (*Cajas*) by September 2011; and measures to strengthen the fiscal framework and improve the functioning of labour markets are part of the necessary Spanish agenda.

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1. See the evidence in Darvas, Pisani-Ferry and Sapir (2011) and, for an update, Darvas (2011).

This state of affairs implies that euro-area governments can be expected to agree on additional official finance for Greece, for a long enough period to cover its financing needs until it is able to borrow on financial markets – the so-called second programme. At current interest rates, however, this lending would further endanger sustainability, it would soon lead to a level of interest payments to foreign official creditors that would be unacceptable to the Greeks and could thus further undermine political stability. Euro-area leaders could therefore agree on a significant reduction of the interest rate charged on official loans.

This option raises a number of issues that leaders will need to sort out. First, EFSF support provided within the framework of a second programme can – and should – be provided at the interest rate at which the EFSF itself can borrow on the market, plus a small margin to cover the operational cost. Indeed other non euro-area countries receiving assistance (Hungary, Latvia, and Romania) receive lending at European borrowing rates plus a small operational surcharge. But lowering the interest rate to a level close to the German Bund rate will be perceived as unfair by other euro-area countries, including Spain and Italy, which need to pay higher rates on the debt they issue to finance bilateral loans. Because of equal treatment, this option will also have to be applied to the euro area's two other programme countries, Ireland and Portugal. Second,the German government will have to clear *ex ante* if such a step would be compatible with rulings of the German constitutional court. So far, delivering assistance at a significant fee, thus making it compatible with the 'no-bail-out clause'[2], has been an important argument for the German government. Third, taxpayers could legitimately question the provision of subsidised loans to Greece, especially in the absence of private-sector involvement.

The need to avoid the burden of adjustment falling on taxpayers in full is a justification to seek political agreement that any future cost resulting from assistance to Greece (whether this takes the form of a loan provided at favourable rates or eventual debt forgiveness) would be entirely covered by an exceptional levy on financial institutions. The levy could be proportionally reduced for institutions that are taking part in domestic or cross-border mergers and acquisitions indeed with the purpose of reinforcing their own capital ratios.

Furthermore, any new financing programme implies a reduction in the exposure of the financial system to Greece, thereby shifting more of the burden of an eventual restructuring onto the official creditors. There is therefore a need to keep the private sector on board as much as possible. But ambiguity remains on what this means. European banks remain divided on the exact shape and form of such a solution. Some remain reluctant to recognise that roll-overs will not be sufficient and that significant reductions in the net present value of future repayments are necessary to restore Greece's solvency.

European leaders should start applying moral pressure to create the necessary incentives for private-sector participation. To signal the need for debt reduction, and support for it, the leaders should request EFSF support for an immediate bond buy-back programme. The programme, of limited size (say, €50 billion), would crystallise immediate losses and achieve some limited debt reduction (of about 10 percent of GDP at most). By itself, such a move would not suffice to change the debt equation materially, but would hopefully open the way to more ambitious initiatives. In the short term the EFSF could lend to the Greek government to finance buybacks, but it would be desirable to reopen the EFSF (and European Stability Mechanism) package to include the possibility of purchases on the secondary market.

Notwithstanding these steps, a comprehensive debt restructuring programme needs to be urgently planned and prepared. To this end leaders should also request from the ESRB, whose role is to contribute to the 'prevention or mitigation of systemic risks to financial stability', an immediate evaluation of the risks to financial stability involved in a future restructuring of sovereign debt in the euro area, and proposals for mitigating the risks[3].

Summing up, the European leaders are not in a position to take bold decisions. But they can set new directions in the management of the Greek debt crisis by:

2. Article 103 of the Treaty states in fact that responsability for repaying the public debt rests with the debtor, and no other monetary union member shall be considered liable for the commitments of other countries.

3. See Wolff (2011).

- Lowering the interest rate on official assistance to the lowest economically-possible level.
- Committing politically to make the financial sector pay for any public finance resulting from official assistance to Greece.
- Request from the EFSF support for an immediate bond buy-back programme (and agree on changes to the EFSF/ESM mandate).
- Request from the ESRB an immediate evaluation of the risks to financial stability involved in a future restructuring of euro-area sovereign debt, and proposals for mitigating the risks.

## 2 DEVISE A GROWTH STRATEGY

To secure the solvency of Greece, debt relief is only a temporary fix. More fundamentally, a serious growth revival programme needs to be put in place. A number of fundamental problems need to be addressed:

- **First**, Greek banks are in a precarious state, having suffered losses on their loan portfolio, and they are massively exposed to sovereign default risks. The recent stress tests have indicated that their holdings of sovereign bonds are twice as high as their core Tier-1 capital. In these conditions Greek banks are cut off from access to market liquidity and are subject to deposit withdrawals (IMF projects deposits at end-June 2011 to be 15 percent below June 2010 level).
- **Second**, domestic demand has fallen dramatically as a consequence of the ongoing adjustment. Year-on-year growth of domestic demand was -10 percent in the first quarter of 2011, contributing in a major way to GDP decline (-6 percent in 2011Q1) and to the rise in unemployment. Leverage remains high and balance-sheet adjustment is only starting and is likely to last for a decade[4]. Continued recession threatens the achievement of fiscal objectives and the political sustainability of the adjustment.
- **Third**, Greece is not competitive. European Commission estimates suggest that the real effective exchange rate was overvalued by up to 20 percent in 2008[5]. Competitiveness has improved since, thanks to nominal wage adjustment (-6 percent year-on-year at end-March 2011) but the productivity cycle limits reductions in unit labour costs. Greece in the coming years needs to channel capital and labour to the traded-goods sector and this requires a depreciation of the real exchange rate. The more front-loaded this depreciation can be, the more promising it is for adjustment and the revival of sustainable growth.

Immediate action should be taken to address these challenges. To strengthen the banks, money in the current EU/International Monetary Fund programmes earmarked for the banking system needs to be used and possibly topped-up to ensure the Greek banking system is sufficiently capitalised to provide credit. At the same time, the EU should encourage the takeover of Greek banks by foreign banks. To support domestic demand and give Greece a chance to grow, the short term pace of fiscal adjustment should be slowed. But immediate fixes will not be enough.

Greece needs an economic strategy to complement the structural reforms introduced within the framework of the EU-IMF programme, foster productivity and reorient the economy towards external demand. EU leaders should therefore provide support to an economic revival strategy that encompasses a Greek economic revival fund which will be used for four priorities.

### a) A Greek economic revival fund

There is no scarcity of financial means for a growth-revival strategy. Under the current EU multiannual financial framework 2007-13, Greece still has more than €12 billion in unused funds, in other words more than 5 percent of GDP. Moreover, the available funds could be used to leverage EIB loans, for which Greece has applied relatively less than other southern European countries[6]. Assuming one third of the unused funds is used to finance EIB-like projects in energy, transport and telecommunications, and EIB loans finance 50 percent of each project's total costs, as standard, the potential size of the growth fund available for the 2011-13 period would increase to €16 billion or about 7 percent of GDP. These far from trivial numbers would not involve any additional transfer to Greece beyond what has been already earmarked in the EU budget.

4. See Ruscher and Wolff (2010).
5. European Commission (2010b).
6. Marzinotto (2011).

*'The Commission should propose special legislation to reallocate to a Greek economic revival fund uncommitted Structural and Cohesion Funds earmarked for Greece within the framework of the 2007-2013 financial perspective.'*

Early disbursement of the funds that have already been allocated to Greece at the beginning of the financial framework needs to be secured. The Commission should propose special legislation to reallocate to a Greek economic revival fund uncommitted Structural and Cohesion Funds earmarked for Greece within the framework of the 2007-2013 financial perspective. This Fund should be used to support the growth and competitiveness components of the EU-IMF programme; its priorities should be decided within the framework of this programme. Legislation to this end should be adopted urgently by the Council and the European Parliament, so that it is effective before year-end[7].

Of course the delivery of these funds matters. Structural Funds in the past have rarely fostered sustained growth. They have mainly been used for investment into physical infrastructure which was initially necessary but eventually fuelled construction booms. Moreover, the co-funding mechanism created political rents and also outright corruption. Future disbursements will therefore have to address the issue of the governance of funds as well as their use. In the following, we suggest four specific destinations for funds, with €4 billion allocated to each over the 2011-13 period.

### b) A programme to increase the quality of higher education

Prior to the crisis, the quality of education was identified as an serious impediment to Greek growth. There is now a risk that budgetary adjustment will result in further deterioration in the quality of the higher education system. €4 billion from the Revival Fund should be allocated to financing institutions of excellence, providing means-tested scholarships and financing mobility programmes.

### c) An internal devaluation

Greece needs to export more goods and services. The Greek manufacturing sector is relatively small by European standards but was not subject to the same dramatic downsizing seen in the rest of the euro area over the last decade. Nevertheless, European Commission research has shown that a large proportion of Greek corporations already have some export basis[8]. In terms of services, tourism is a prime price-elastic export industry. Fixed costs for exporting are thus low and a marginal improvement in price competitiveness could quickly benefit exports.

Reducing labour costs in the tradable sector should thus be prioritised. Eventually this reduction will come from the wage-and-price adjustment process at a limited cost to the wage-earners (because the whole price system will have adjusted), but the short-term cost could be high for employees whose wages adjust first. The Economic Revival Fund should be used to smooth this adjustment.

The combined wage bill of the manufacturing and hotel and restaurants sectors – a reasonable approximation of the tradable sector – amounts to €11 billion. €4 billion from the economic revival fund should be earmarked for temporary wage subsidies in these sectors, to be introduced on 1 January 2012 and phased out during 2013-15. These subsidies should serve to front-load the reduction of labour costs while offsetting part of the cost to employees, and foster the internal devaluation process. Some wage subsidies might more specifically target R&D-intensive sectors to boost their growth potential, reverse the brain drain, help attract back Greek nationals living abroad, and prepare the ground for an upgrading of value chains[9].

In order to avoid wage-cost reductions being captured by rents, the internal devaluation will need to be accompanied by strong measures to reduce market power and foster competition. It will therefore be imperative that the European Commission, with national competition authorities, uses all available instruments to foster competition and reduce rents. For example, reducing administrative burdens on firms to allow entry by reducing

7. Some funds may be already allocated through the JEREMIE programme without the need for special legislation. JEREMIE is an initiative by the Commission and the European Investment Fund through which Structural Funds are paid up-front to support small and medium enterprises (SMEs) and their most innovative projects. The funds are typically collected in a holding fund and managed by selected financial intermediaries. With the advantage that EU payments are made up-front comes also the fact that financial intermediaries and possibly even the EIB are involved in the evaluation and monitoring of the projects, softening concerns about poor governance.

8. European Commission (2010a).

9. If the activities in R&D sectors are conducted by SMEs, subsidies may be financed by Structural Funds through the JEREMIE programme (eg €2 billion) and thus implemented almost immediately and in a flexible setting.

legal requirements would be a first important step in the direction of changing the domestic competitive environment. Indeed, these types of measures also have the merit of having quite immediate strong macroeconomic effects.

### d) Enterprise support to foster the upgrading of production and exports

Economies grow by upgrading the products they already produce and by producing new products. Given a certain knowledge set, it is easier to upgrade to similar products than to completely different ones. Greece has high potential for upgrading. Hausmann (2011) finds that Greece could expand its manufacturing of agricultural machinery and appliances, metal-forming machine tools and dairy machinery, and electric equipment for internal combustion engines and special textile products[10]. For the process to succeed, the most innovative firms and small and medium start-ups need to have access to finance[11]. This is even more urgent in a situation in which weakened banks might restrict access to credit. €4 billion from the economic revival fund should be redirected to providing credit for SMEs and capital for investment in the production of new products. Public support should be provided on a competitive basis to sectors that have the highest potential for fostering efficiency[12].

### e) 'Lighthouse' innovation projects

Greece needs a greater variety of products and high added-value production if it is to substantially increase exports and income. However, such advancement to new technological levels is unlikely[13]. A further €4 billion should be devoted earmarked to support a programme in this field.

The economic revival fund should be earmarked to foster the creation of several local centres of innovation that combining centres of academic excellence with special business zones to allow for technological spin-offs. Relying on local universities only will however not be enough to foster synergies. Instead, high ranking research institutions in the rest of Europe (such as Oxford University or the Max Planck Society) should be provided with a financial incentive to set up campuses in Greece. The university subsidiary should focus on a few selected key areas (for example bio-technology or green technology). Independent management of the subsidiary should ensure excellence at a global level by avoiding influence from other parties and being able to attract global top researchers with attractive salaries. Such academic centres of excellence could be the nucleus of a new growth centre. For example, Greece's strong renewable potential is in danger of being under-utilised.

This economic revival programme has a strong interventionist flavour. The reason for this is that as long as the price system delivers wrong signals – because of the price distortions accumulated in the first decade of monetary union and the time it takes to correct them – horizontal measures alone cannot be expected to trigger the necessary shift of resources towards the tradable sector. Without specific incentives, resource allocation is bound to remain distorted as long as prices are wrong. Moreover, there is significant evidence that strong incentives are needed to foster innovation and technological change. These considerations underpin the industrial policy approach we are advocating.

However, financial incentives by themselves will not be enough. Institutions fostering entrepreneurship and research need to be improved. The rule of law, a corruption-free environment and efficient state apparatus are key determinants of innovation and investment. The European funds should therefore be conditional on improving the institutional environment.

In sum, early and targeted disbursement of EU grants does not guarantee that resources will be efficiently managed. Yet, fixing the priorities and coordinating structural reform interventions with EU-IMF authorities would be a necessary and

*'Relying on local universities only will however not be enough to foster synergies. Instead, high-ranking research institutions in the rest of Europe should be provided with a financial incentive to set up campuses in Greece.'*

10. Hausmann (2011).

11. The EIB provides credit lines to national financial intermediaries to finance these types of initiatives, or Structural Funds can be utilised under the umbrella of the JEREMIE programme (see note 7).

12. The case for such intervention is made in Aghion *et al* (2011).

13. See Hildago *et al* (2007).

*'In many countries banks are excessively exposed to threats to the solvency of their own sovereign, and this is a major weakness of the euro area. When this solvency is called into question, banks are immediately affected.'*

decisive step towards efficient management of the available resources.

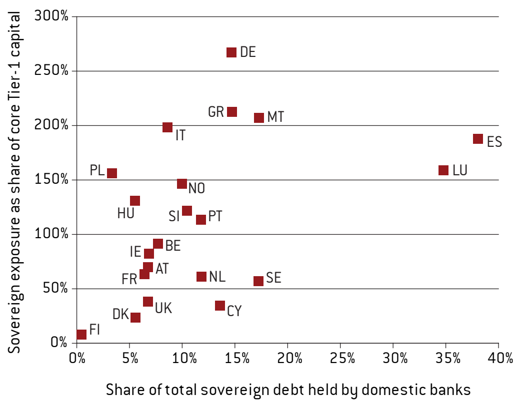
## 3 INITIATE SYSTEMIC REFORMS TO REDUCE FINANCIAL FRAGILITY

Fixing the Greek case is an absolute priority but European leaders should also initiate broader euro-area reforms and devise mechanisms to prevent contagion. The recent speculative attacks on Italy and Spain have demonstrated the inherent fragility of the euro area.

The correlation of banking crises and sovereign crises has been a distinctive feature of recent turmoil in the euro area. It has been manifest in the Greek, Irish and Spanish cases, though the direction of the causation is not the same for different countries. Recent market reactions to the bank stress tests indicate that the phenomenon may affect other countries, not least Italy. This represents a threat for the future, endangers the stability of the financial system, and makes bank runs more likely.

FIgure 1, on the basis of the recent stress test results, provides a good indication of where each national banking system stands in terms of vulnerability. The vertical axis shows the exposure ratio of own-country public debt domestic banks'

**Figure 1: Banking-sector exposure to the domestic sovereign in the EU**




Source: Bruegel based on EBA stress tests.

exposure to their own country's public debt relatively toto core Tier 1 capital for all domestic banks surveyed in the recent stress test exercise. This ratio is indicative of the potential repercussions of a country's sovereign debt crisis on its own banks. The horizontal axis shows the exposure to ratio of own-country public debt relatively domestic banks' exposure to their own country's public debt to total public debt. It measures the share of losses they would bear in case of a sovereign debt crisis in their country.

Figure 1 indicates that that in many countries banks are excessively exposed to threats to the solvency of their own sovereign, and this is a major weakness of the euro area. When this solvency is called into question, banks are immediately affected because of their direct exposure and because the of the sovereign's diminished ability to come to their rescue. This vulnerability soon shows up in stock-market depreciations, credit-default valuations, credit spreads and, possibly, bank runs. This in turn weakens further the situation of the sovereign, because of expectations of bank rescue costs.

This vicious circle must be broken. Sovereigns should be better protected against the failure of their banks, through the centralisation of supervision and the mutualisation of deposit insurance. An immediate response could be for the EFSF to explicitly guarantee all euro-area national deposit-insurance schemes[14]. Such a measure, however, would also require a significant stepping up of the supervisory powers of the centre, to align incentives and avoid moral hazard. The European Banking Authority could be given such additional power. To complement this, banks should be better protected against the failure of their sovereigns, through diversification of their bond portfolios. This can be achieved through setting regulatory ratios; alternatively, it is also the most potent justification for introducing Eurobonds, because they would offer a natural diversification instrument[15].

In the same way that they initiated reforms of the

14. See Véron (2011).

15. Pisani-Ferry (2011).

euro-area surveillance system in 2009-10, the EU leaders should call upon the President of the European Council and the European Commission to prepare proposals in this field.

## CONCLUSION

The euro area's leaders cannot be expected to solve lingering problems by the stroke of a pen. They cannot be expected either to find unanimous agreement in fields in which they have had consistently different positions. But they can demonstrate initiative by addressing three concerns simultaneously: sovereign solvency, growth, and systemic fragility. A meaningful package is within reach. This opportunity should not be missed. Our proposal is an immediate action plan but more ambitious reforms will be necessary.

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