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Making the Eurozone Function Again: A Solution for the European Debt Problem Is Hard But Not Impossible

KEY MESSAGES

- **The Eurozone is stuck in an inefficient equilibrium with high public debt and no policy discipline. The no-bailout rule is not credible**
- **This article proposes a radical two-stage solution for the restructuring of excessive public debt and to eliminate the incentives for undue public borrowing in the future**
- **"Restructuring" would amount to a Euro-wide collective retirement of excess debts. Calculations are presented for two alternative procedures**
- **Borrowing discipline would be restored by the introduction of a tax on subsequent borrowing if it violates a critical level, say a 100 percent debt-to-GDP ratio. This is called a "Tobin tax"**
- **The solution suggested, which could be compared with the US state-level rules of a balanced budget requirement, introduces radical policy discipline instead of relying on market discipline, which tends to come too late.**

The Eurozone's debt problem remains a top priority for a policy reform in the European Union. The public debt ratios relative to the gross domestic product in seven of the monetary union's member states continue to exceed the 100 percent level. It is not only high in Greece (193 percent), Italy (151 percent), and Portugal (127 percent), but also in Spain (118 percent), France (113 percent), Belgium (108 percent), and Cyprus (104 percent).

Why care about such high debt ratios? It is a matter of simple algebra: when the economic growth rate exceeds the market interest rate, debt ratios start declining over time. In the absence of such growth prospects, however, persistent national incentives for resisting reforms in spending push the problem into the future.

To monitor and control national fiscal policies in the context of the common currency, the European Stability and Growth Pact—originally signed in 1997 and subsequently reformed several times—dictated that the budget deficit should not exceed 3 percent of GDP and that public debt shall not surpass 60 percent of GDP. Narrow-minded national interests, however, eventually circumvented the commitment to the collective aims of the monetary union. This state of affairs calls to mind the pioneering theory of coalitions developed by Mancur Olson, which addresses persistent conflicts between a coalition and the members of that coalition. Olson (1965) predicted that collectives typically face a commitment problem among their members, as the national benefit/cost analyses lead to the rejection of the interests of a collective in favor of national aims. In his 1961 paper on optimal currency areas, Robert Mundell, a Nobel Laureate in Economics also known as "the father of the euro," suggested that currency unions should recognize the risk of asymmetric demand shocks.

After the euro was created, it became evident that interest rate instability had been replaced by an incentive for excessive borrowing among the member states. Incentives were also distorted in banking. Ultimately, market forces—not the policymakers—signaled that enough was enough with Greece. The resulting German–French banking crisis had to be resolved in terms of the collective bailout operations of the other member states, the ECB and the IMF. The welfare loss to the Eurozone citizens was substantial.[1]

It was left to the ECB and its then-Chairman, Mario Draghi, to save the euro with his 2012 "whatever it takes" speech. His words carried enough weight to carry the day but could not make the Eurosystem function properly. Incentives had to be created for euro banks to finance their home states through the Long-Term Refinancing Operations (LTRO) program. Moreover, the quantitative-easing policy turned the ECB into the holder of a huge volume of junk bonds, raising serious questions about the legitimacy of its policies.

In the aftermath of the process, the ECB's rate on basic operations was reduced to zero, and the overnight rate for lending to banks was lowered to negative territory. The market rates of interest on the government debt of Germany and Finland turned negative, as safe havens were in great demand. Zombie firms were kept alive. Some fatal deficiencies were quite apparently embedded in the euro architecture. Understandably, they are related to the incentives created for the euro banks and to the demand for the collective bailout of the member states once a crisis is at the door.

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[1] My research group of 12 economists had estimated that the welfare loss to the citizens of the Eurozone member states amounts to about 10 percent of GDP according to data comparing the performance of the Eurozone with that of the US economy up to 2014 (Kanniainen 2014).

In the Eurozone, the sovereign bond holdings of the European system of central banks amounted to €4,713bn when this paper was written.[2] The Eurosystem is tied to an equilibrium with inefficiencies in the functioning of the financial system, lack of policy discipline, and dearth of trust concerning the survival of the Eurosystem. The Targeted Longer-Term Refinancing Operations (TLTROs), a new instrument for monetary policy, was created in March 2021 to carry on with the unconventional monetary policies.

The European monetary union never recovered from the sovereign debt crisis of the 2000s. Currently, and in addition to the high debt of Greece, there are concerns about Italy's ability to pay its debts. Despite the lack of a solution to the debt problem, the ballooning inflation made the central bank go back to its traditional role. Its interest rates, which had not been raised for 11 years, have been raised several times in 2022 and in 2023, in a process that may not be yet over.

A POSSIBLE SOLUTION

In November 2022, the European Commission developed a set of orientations for a reform of the economic governance framework. The purpose was to strengthen debt sustainability and promote sustainable and inclusive growth among all member states. In March 2023, the European Council endorsed these guidelines and agreed on a reform of the EU economic governance framework. The national medium-term plans of member states with a public debt-to-GDP ratio above 60 percent should ensure that the ratio is kept on a steadily diminishing course.

Earlier, several academic initiatives suggested policy reforms, including a new debt instrument suggested by Brunnermeier et al. (2011), consisting of European safe bonds (ESB). The purpose of such bonds is to eliminate the perverse incentives that tie euro banks to sovereigns. The debt would be sliced into senior and junior claims, and any failure of a sovereign state to honor its debts would be absorbed by the holders of the junior security. The banks could thus avoid being overexposed to national bonds. The trouble with such a proposal is that the highly indebted countries would be able to continue issuing debt at favorable terms. The principle of market discipline would not kick in. Moreover, the systemic risk would remain. Therefore, the reform would not be crisis-proof, and the no-bailout rule would perhaps not be effective.

Another proposal was made by Fuest and Heinemann (2017) with the purpose of reinstating market discipline and the no-bailout rule. If the member state's structural budget deficit exceeds 0.5 percent of GDP, its excess debt would be issued in the form of accountability bonds, i.e., junior bonds that would lose their value as soon as the issuing government defaults on "regular" bonds. The ECB would not be allowed to buy accountability bonds. The problem, however, remains that the proposal tackles new debt, but appears not to solve the issue of existing debt. Moreover, the no-bailout rule had failed earlier. Why would it not re-enter through the back door?

One more proposal was made by Vihriälä (2020). He suggested debt relief for the excessive debt of Eurozone member countries by transforming part of the debt into perpetual zero-interest debt in the balance sheet of the ECB. The total debt would have to be "big enough." As a silent feature, the suggestion is not a free lunch. Instead, all euro member countries would implicitly finance the package through the capital their central banks hold in the ECB. The problem with the suggested solution is that no barriers are provided against the moral hazard incentive of accumulating additional debt in the future.

The Eurosystem problem arises fundamentally from the lack of credibility of the no-bailout rule and the resulting moral hazard arising among the member states and within the banking sector. The earlier proposals appear not to be crisis-proof. While they appear to rely on market incentives, it is unclear what would make the ECB stay out of the game if a crisis emerges. It could not stay passive in 2021 when the Covid-19 crisis swept the world.

The procedure proposed in this paper is much more strict than the previous ones in emphasizing policy discipline instead of relying solely on market discipline. It suggests a policy reform in a two-stage procedure. In particular, it suggests a final and once-for-all restructuring procedure of the public debt of the highly indebted member states, as well as a punitive tax on new debt if a member country violates the suggested limit.

IT IS DIFFERENT IN THE USA

The European trauma stems from the fact that no fiscal rule can replace policy discipline in safeguarding a proper set of incentives. Rules do not function if the incentives are distorted and if no plausible sanctions are levied on fiscally wayward member states. It is altogether different in the United States, where each state is, in practice, subject to balanced budget rules. With the exception of Vermont, all states are subject to deficit or debt limitations. Such policy discipline does indeed function: the median debt ratio is 16 percent across states, with a range of +/− 10 percent.[3] The policy discipline arises from the no-bailout principle, which has been effectively in operation since the no-bailout decision of the US Congress in the 1840s, as explained

[2] https://www.ecb.europa.eu/pub/annual/balance/html/ecb.eurosystembalancesheet2021~f9edd2ff57.en.html. The Asset Purchase Program (APP) amounts to €3,300 bn.

[3] The highest rate in 2019 was 27.83 percent in Kentucky, while the lowest was in the District of Columbia at 3.94 percent (source: Statista). The Illinois interest rate margin of exceeds 5 percent, but the mistrust is due to its underfunded retirement plan.

by Sargent (2012). As a result, several states have defaulted once the decision came to be tested. Policy discipline is reinforced by the Fed in that it stays away from the market for state borrowing.[4]

EUROZONE: RESTRUCTURING AND TOBIN TAX

In the Eurozone, debt restructuring is feasible under the current rules of the European Stability Mechanism.[5] They are designed, however, to address the problems of a single country. What this article suggests is the restructuring of the whole Eurozone. "Restructuring" in the suggestion means "a euro-wide collective, once-and-for-all mutual bailout of excess debts" instead of just "debt relief." As previously mentioned, the safe bond and accountability bond suggestions for a reform did not address the burden of the existing debt.

To make the euro function again, however, debt restructuring would not suffice. What is also needed is to eliminate the incentives for member states to accumulate excessive debt in the future. The present suggestion differs from the safe bond or accountability bond approaches in that it effectively imposes the no-bailout principle.

Two steps are envisaged. In the first step, the portion of the debt exceeding the 100 percent debt-to-GDP ratio will be retired jointly by all member states. All member states participate in the restructuring, including the indebted member states themselves in proportion to the capital key of their share in the ECB. The calculations show clearly that the debt problem is indeed a tough one. Such a mutual bailout leads to a very heavy burden on some of the member states. Therefore, an alternative calculation is presented where the "acceptable" debt ratio is taken to be higher, 127 percent. Then, only the Greek and Italian excess debts are mutually eliminated.

In the second stage, a tax will be imposed on a member country in case its debt ratio climbs above the threshold. The tax, which I call the "Tobin tax," can be collected from the investors who buy the debt or, alternatively, from the member's pandemic recovery fund (or any other transfer program within the European monetary union). For the tax incidence, it does not matter how the tax is collected. The responsibility of accepting the tax should be introduced into European legislation, and it goes without saying that the tax rate must be sufficiently high to work towards imposing policy discipline. The debt program should be implemented through "backward induction:" first the tax in the legislation, and then debt restructuring.

HOW MUCH MONEY IS INVOLVED?

In Table 1, I present the public debt figures for the euro member countries, the GDP and the excess debt, i.e., the portion that exceeding the 100 percent of GDP level (Excess debt (1)) or, alternatively, the 127 percent level (Excess debt (2)).

In Table 2, I present the capital keys and the national shares of the suggested programs of restructuring.

The total bill for restructuring under Excess debt (1) amounts to €1,701.0bn. This can be managed by the ECB writing off the equivalent amount of the member states' bonds it holds.

In both proposals, the financial burden needed to carry out the program is huge. It could, however, be compared with the Recovery and Resilience Facility (RRF), which is the largest component of Next Generation EU (NGEU), the European Union's landmark instrument for recovery from the Covid-19 pandemic. The RRF will provide grants of up to €312.5bn and loans of up to €360bn at 2018 prices, totaling up to €750bn (Bruegel 2022).

The 60 percent rule of the Growth and Stability Pact was not derived from macroeconomic theory, nor is the suggested 100 percent debt ratio in this article. Rather, it arises from the psychology of the markets in pricing public debt. It is the markets that ultimately decide on the various countries' likelihood to repay their public debt. Moreover, it should be pointed out that the suggested borrowing limit does not prevent

[4] The Covid-19 pandemic prompted the Fed to issue a statement that it can help the states. Illinois resorted to this opportunity, borrowing $3.2 bn from the Federal Reserve, which may have been a potential mistake of the Fed.

[5] Gross (2017) suggested that the ESM already constitutes, to a large extent, a "European Monetary Fund."

Table 1

Calculating the Excess Debt (1) and the Excess Debt (2)

Country	Debt € bn	GDP € bn	Excess debt (1) € bn	Excess debt (2) € bn
Greece	353.4	182.8	170.6	121.24
Italy	2,677.9	1,775.4	902.5	433.14
Portugal	269.2	211.0	58.2	
Spain	1,427.2	1,205.1	222.1	
France	2,813.1	2,508.9	304.2	
Belgium	548.7	506.2	42.5	
Cyprus	24.3	23.4	0.9	
Total			€1,701.0 bn	€544.38 bn

Source: Author's compilation.

Table 2

The Capital Keys and the National Shares of the Restructuring Programs

Country	Capital key	Restructuring burden € bn (Program 1)	Restructuring burden € bn (Program 2)
Belgium	0.36432	61.97	1.98
Germany	26.3615	448.41	143.50
Estonia	0.2817	4.79	1.53
Ireland	1.6934	28.80	9.20
Greece	2.4735	42.07	13.45
Spain	11.9246	202.83	64.89
France	20.4243	347.42	111.19
Italy	16.9885	288.97	92.44
Cyprus	0.2152	3.66	1.17
Latvia	0.3897	6.63	2.12
Lithuania	0.5788	9.85	3.15
Luxembourg	0.3294	5.60	1.79
Malta	0.1049	1.78	0.54
The Netherlands	5.8604	99.69	31.90
Austria	2.9269	49.79	15.89
Portugal	2.3405	39.81	12.73
Slovenia	0.4815	8.19	2.61
Slovakia	1.1452	19.48	6.23
Finland	1.8369	31.25	9.96
Together		€1,701.0 bn	€544.38 bn

Source: Author’s compilation.

additional borrowing: it allows it, but conditional on the growth of the economy.

POLICY CONCLUSION

The Eurozone will continue to suffer from financial fragility for as long as the central bank must intervene in financial markets to keep the euro alive. Market discipline in pricing public debt is powerless, and the bond prices are artificial. Such mispricing is detrimental to the investment strategies of European firms and explains why the Eurozone has a gloomy future in the minds of the investors.

In the current article, calculations are presented for a once-and-for-all mutual debt retirement program for the portion of the debt that exceeds the 100 percent, or alternatively 127 percent, of GDP ratio. To carry out the suggested program, all member states would be involved in the collective program, including the debtor countries themselves.

The calculations show that the burden of restructuring would fall particularly heavily on Germany and France. These were, however, the member states that benefited most from the collective bailout of their banks during the Greece crisis.

Clearly, the national sovereignty of the member states may pose a problem under this proposal. One can, however, ask how the markets will interpret such a lack of commitment to the common target of fixing the euro if a member state refuses a tax on its excessive borrowing.

Cross-country transfers have not been unusual within the Eurosystem; they are rather the rule. But this proposal opens up a different future. Imposing a strict limit in the sense of a “Tobin tax” on excessive indebtedness may provide sound policy discipline, restoring trust and credibility in the financial system. Some tend to think that creating the euro was the error of the century in the first place. Maybe it has never functioned properly. Maybe it sometimes did. If the purpose is to make the Eurozone function again, something radical needs to be done.

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