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Central banks to assume no further risks

Only policymakers should provide Greece with more funds

The creation of the European Monetary Union (EMU) was a quantum leap in the European integration process. The population of the euro area – now numbering more than 300 million – has a successful currency that is stable both within and outside the euro area. The single currency has provided substantial benefits to member countries, for example by making exchange rate fluctuations and transactions costs obsolete. In return, the member countries have to observe the agreed regulations and obligations. The current crisis is not a crisis of the euro: it is a sovereign debt crisis of individual, smaller euro-area countries which arose, not least, because they disregarded the rules. This crisis is the most serious test the euro area has faced to date, and as a result, it finds itself at a crossroads. The solution to the crisis calls for a certain flexibility as well as for adjustments to the general framework in order that past misjudgements and new developments are taken into account. However, in our efforts to deal with trouble spots we must not erode the regulatory foundation of EMU.

In a show of solidarity, individual member countries are currently being granted aid in the billions of euros to stretch over a number of years the economic adjustment process – which is unavoidable given the huge fiscal policy difficulties and the need for macroeconomic reform – and to make it less severe for the people. But at the same time, these countries are called upon to implement the necessary reforms and consolidation measures. Solidarity is not a one-way street: it works both ways. If a country were to decide not to fulfil the obligations tied to assistance, there would be no basis for providing assistance. In such a case, the country would have to cope with a far more abrupt adjustment. Ultimately, the principle of a country's national responsibility places a decision of such magnitude in the hands of its own policymakers. But then, the other member states, too, would have to bear considerable uncertainty, risk and additional stabilisation costs. Yet the euro would also be able to cope with this – by no means desirable – test of its resilience.

EMU is a community of self-responsible states. Its members agreed to the political independence of monetary policy, while stipulating by law that the safeguarding of price stability would be the prime task of monetary policy. This independence is assured, amongst other things, by fiscal rules that are designed to restrict sovereign debt and by a ban on financing sovereign debt by printing more money ("monetisation of sovereign debt"). Moreover, the principle of no-bail-out was legally anchored. For, in contrast with a purely national monetary policy such as that in the USA, the single monetary policy in a monetary union can lead to a redistribution of burdens and risks between the taxpayers of the individual member states. However, the legally enshrined separation of monetary and fiscal policy tasks within EMU prohibits using monetary policy for this purpose and reserves this – if at all – for fiscal policy and the democratically elected national parliaments.

The sovereign debt crisis and the monetary and fiscal-policy measures to counter it have put considerable strain on this monetary union framework. In spring of 2010, monetary policymakers adopted a raft of conventional and unconventional measures aimed at stabilising the financial system, which resulted in the central banks assuming substantial risks. This may have been justifiable as a temporary measure to avert a serious crisis. However, these measures far exceeded the monetary policy mandate and blurred the boundary between monetary policy responsibility on the one hand and fiscal policy responsibility on the other. If additional tasks and risks are shifted to monetary policy on a permanent basis, there is a danger that the monetary policy mandate of safeguarding price stability will suffer. It is therefore important for monetary policy that the risks that have been assumed are reduced now and are not extended further so as not to risk a loss of credibility. From now on, decisions about the assumption of further risks must be taken by the governments and parliaments which are democratically authorised to take them.

What does this mean in the current situation? In May 2010, an extensive bailout package was put together for Greece to protect financial stability in the euro area as a whole. It was then, and it still is, possible to safeguard Greece's solvency by rigorously pursuing a consolidation and reform path spanning a number of years – without imposing a haircut. The other member states and the IMF released the financial support on these premises and on strict conditionality. Greece promised to implement an adjustment programme which would be continuously monitored, and to correct any slippage in order to ensure compliance. One year on, we find that although Greek efforts have been substantial, the results fall short of what was agreed, and the need for correction is considerable. The return of Greece to the capital market – a target originally set for 2012 – is now surely out of the question.

Moreover, investors and observers are clearly growing increasingly doubtful about Greece's ability to secure a political consensus that will allow the country to meet the conditions for the financial aid and so remain solvent. Against this background, discussions are currently underway to decide whether and on what conditions Greece should receive further aid. Besides additional consolidation measures and stepping up privatisation, it has been suggested that private creditors bear a considerable part of the financial burden. Specifically, debate centres on extending the maturity of outstanding Greek government bonds by several years. This is intended to reduce the financing gap in the years ahead, thereby lowering the volume of, and the risk inherent in, a new, more extensive assistance programme.

From the monetary policymakers' viewpoint, these suggestions would have to satisfy the above principles. This means that the risks for the Eurosystem inherent in the efforts to resolve the sovereign debt crisis must be scaled back, and that monetary policy and fiscal policy responsibility must again be adjusted accordingly. Subject to these requirements, private sector participation is both right and proper in principle so that – generally speaking – investors are not absolved of responsibility for their investment decisions and so that – in this particular case – the risks for the taxpayer are reduced and Greece's fiscal sustainability is improved. By no means must debt restructuring take the pressure off Greece to make the necessary adjustments, far less appear to be a more attractive alternative to reform. It was with these thoughts in mind that the Bundesbank proposed, with a view to resolving future crises, incorporating an automatic, predetermined maturity extension option into the terms and conditions of government bonds from 2013 onwards. This would have many advantages. Extending the maturity would not constitute a credit event. Moreover, it would take effect before the first payment of state aid were made, and such aid might be smaller as a result of it.

In the current debate, however, the aim is to change the relationships that already exist between debtors and creditors. I believe there can be no objection to a voluntary maturity extension. The question is rather how far investors' willingness to participate would go. If maturity extensions were forced upon creditors, on the other hand, the risks would far outweigh the gains, as then a credit event probably would be triggered, putting financial market stability at considerable risk. The distressed sovereign bonds would no longer meet the central bank's collateral requirements. On top of that, there is a danger that investors would then consider the bonds of other countries, too, as entailing greater risk. This in turn could lead to financing difficulties for those countries and touch off considerable turbulence. Compared to these risks – which would become inevitable if Greece did opt out of meeting its obligations – the positive effects of the proposal would only be limited. Given that extensive state aid has already been given, the quantity of Greek sovereign bonds held by the private sector – with the exception of Greek banks – is no longer as large as is often assumed. Thus, the actual burden to be borne by private investors would probably be limited. Furthermore, it is unlikely that Greece's solvency, which is the yardstick by which the success of the support measures will be gauged, would be improved by forcing a maturity extension on investors.

It is crucial for monetary policy that no further burdens or risks are shifted to the Eurosystem. Thus, policymakers cannot proceed on the assumption that Eurosystem central banks would agree to a lengthening of maturities also for the bonds that they hold or that they would accept bonds of countries considered in-solvent as collateral for refinancing operations. Another problem with extending the maturities of sovereign bonds in this specific situation is that it would make the Greek banks' solvency and liquidity situation markedly worse. Consequently, the Eurosystem would likely find itself confronted with growing refinancing needs while the quality of collateral becomes poorer. For this reason, policymakers must be aware that a comprehensive aid programme for Greece must also include the provision of sufficient funds to protect the banking system; otherwise, the temporary blurring of the boundary between monetary and financial policy that has been tolerated in the face of the current exceptional circumstances might result in monetary policy being increasingly taken hostage on a prolonged basis. Apart from that, the risks would not be eliminated by shifting them to the Eurosystem in contradiction of the monetary policy mandate. They would be hidden at best, and in the end it is the taxpayer who would again have to foot the bill.

The success of the adjustment programme will ultimately be decided in Greece. I still believe that a successful consolidation and reform are possible within the framework of an assistance programme, and I expressly acknowledge the Greek government's efforts in this respect. Moreover, I am very much aware of the great burden this places on the citizens of Greece. It will also take staying power to eradicate the deep-rooted causes of the problems, which include, not least, the lack of economic competitiveness. Yet I am firmly convinced that there is no alternative to a comprehensive reform programme to solve the structural problems once and for all, and that, for this reason, reform is in the Greeks' very own interests.

Seen against this backdrop, it is the prerogative and the duty of fiscal policymakers and the national parliaments to decide whether they will provide further funds to continue the aid programme. If they do, the funds must also be sufficient to support the Greek banking sector. Another point to be considered is that even if aid for Greece were discontinued, substantial amounts would still be necessary to cushion the effects of such a decision on the community, such as contagion to other euro-area countries.

Looking ahead, the present framework needs to be strengthened. This is what the recent decisions concerning the reform of the Stability and Growth Pact, macroeconomic surveillance and the introduction of a crisis resolution mechanism do at least try to achieve. For the future success of EMU, it is indispensible that elected politicians strengthen rather than weaken incentives for sound public finances and for taking responsibility for one's own investment decisions both in the context of these forthcoming reforms and when actually dealing with serious crises. It is the job not least of the central banks and of the Bundesbank to emphatically heighten awareness of this. Their most valuable assets are credibility and confidence in their independence. The euro area will master the challenge the sovereign debt crisis poses provided these assets are not jeopardised.