European Sovereign Debt Crisis Policy Proposal
Presented by the French Republic
9 November 2012
The European Redemption Pact

We propose the enactment of the European Redemption Pact, with several amendments. This pact was proposed by the German Council of Economic Experts in 2011 (Doluca et al. 2012), and again in 2012. The plan is outlined as follows:

The objective of this plan is to pool the debt of several different countries, thereby decreasing the uncertainty of investing in those countries' bonds.

- Each country would still be responsible for 100% of their debt; however, all countries are jointly liable for the ERF.

- This outsourcing of debt to the European Redemption Fund would allow a pooling of risk. For countries such as Italy and Spain, this would allow their interest rates to drop, making repayment more feasible.

- The redemption fund would be comprised of all national debts from each country that exceeds the 60% ceiling mandated by the Maastricht Treaty, to be repaid over the next 20 to 25 years.

- Each country's contribution would depend be calculated in the following way.

\[(\text{Interest ERF} + 1\% \text{ point}) \times (\text{amount to be transferred to the ERF}/\text{GDP of 2011})\]

- Thus countries' payment schedule is dependent on the level of their debt and their GDP. All countries would repay their debt at about the same time.

- Countries running a large deficit will be required to contribute a deficit surcharge to avoid unrealistic consolidation.

- All members of the EZ who were not already involved in the EFSF or ESM could participate.

- Participation is dependent on conditions that they reform their constitution to incorporate the 60% debt ceiling, as well as conform to the fiscal consolidation described in the EFSF and ESM.

- All participating countries would be required to maintain the 60% debt ratio once the excess debt has been allocated to the ERF, and national deficit could not exceed 5% of GDP.

- A specific tax must be earmarked in each country for the specific purpose of interest payments to the ERF.

- Gold reserves and foreign currency reserves would be used as collateral in the event of a country's failure to adhere to their payment schedule.
The pact specifies a 3 to 6 year roll-in period in which national debt would be transferred to the ERF. This would happen through the refinancing of national debt through the ERF until their remaining debt ratio is 60% of GDP.

- Countries with greater need can refinance more quickly in order to access the more favorable interest rates.

Amendments

We propose three amendments to this pact.

1. All countries in the euro zone not already participating in a EFSF or ESM program would be require to enter the ERF. This would allow for still greater diversification of risk, and thus more secure returns on the bonds. Additionally, this would ensure that all countries within the euro zone return to a stable debt level.

2. We propose that each country should pass a constitutional amendment keeping debt below 60%, however, we do not require any restrictions on national deficit, so long as the former hold.

3. We propose that the IMF would back the ERF during the rolling-in period. We do not propose that the IMF contributes any funds, only that they guarantee the debt so as to further dissuade uncertainty.

Supporting Policy

The current crisis can be divided into three related factors, the worldwide recession, the banking crisis, and the sovereign debt crisis. This proposal deals most directly with the sovereign debt crisis, and indirectly with the banking crisis and the recession. Thus additional policy is required to stabilize the European economy. We propose that if at all possible, no further bailouts be given by the ESM. However, the agreements already held by Portugal, Ireland, and Greece with the EFSF and EFSM. These programs are essential to the fine tuned stabilization of those countries in most dire need. These mechanisms were created to alleviate some pressure within the troubled economies and prevent default on sovereign debt.

The European Redemption Pact itself addresses the fiscal policy needed to stabilize the euro zone. The ERP requires adherence of all participants to certain fiscal measures defined in the EFSF, EFSM and ESM. The Fiscal Compact requires countries to ratify provisions in their respective constitutions to retain a balanced budget as defined by the compact, which is consistent with the Maastricht Treaty (European Council).

Additionally, we support the implementation of the Single Supervisory Mechanism, proposed by the European Commission in September and discussed again in October. A European banking union would allow for more precise and effective regulation of the
banking system. As in the U.S. bad loans considerably contributed to the deepening of the recession, and in some countries led directly to the debt crisis.

**Justification**

Uncertainty has been a multiplying factor in this crisis. With the threat of possible default pervasive in the Euro zone, many countries experienced a sharp incline in the interest on their bonds. These risk premiums increased the chance of default on national debt. If creditors could have a more certain guarantee of repayment, the interest rates would be allowed to fall, alleviating some of the problem. Our main focus then should be to restore confidence in the economy and decrease those interest rates, making the repayment possible.

Each country would contribute to the fund in the amount of their national debt that exceeds the 60% ratio.

The European Redemption Pact would do just this. By combining the debt of all Euro zone countries, a new interest rate would be calculated based on the collective risk of the bonds.
This would mean an increase in interest for countries such as Germany and the Netherlands. While this does represent a direct cost to those countries, it is safe to say that at this point any policy will come at such a cost.

source: Doluca et al.

![Table 2: ERP: Key Figures for Participating Countries](source)

<table>
<thead>
<tr>
<th>Country</th>
<th>Gross domestic product</th>
<th>Public debt</th>
<th>Primary balance</th>
<th>ERP bonds</th>
<th>National issued bonds with ERP</th>
<th>National issued bonds without ERP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>€2,020.9</td>
<td>2,166.7</td>
<td>27.9</td>
<td>3.5</td>
<td>3.0</td>
<td>2.5</td>
</tr>
<tr>
<td>France</td>
<td>€2,351.1</td>
<td>1,845.8</td>
<td>-63.8</td>
<td>3.5</td>
<td>4.5</td>
<td>7.0</td>
</tr>
<tr>
<td>Italy</td>
<td>€1,590.1</td>
<td>1,905.9</td>
<td>14.8</td>
<td>3.5</td>
<td>4.5</td>
<td>7.0</td>
</tr>
<tr>
<td>Spain</td>
<td>€1,064.3</td>
<td>861.5</td>
<td>-47.9</td>
<td>3.5</td>
<td>4.5</td>
<td>7.0</td>
</tr>
<tr>
<td>Netherlands</td>
<td>€806.2</td>
<td>424.8</td>
<td>-14.6</td>
<td>3.5</td>
<td>3.0</td>
<td>2.5</td>
</tr>
<tr>
<td>Belgium</td>
<td>€376.8</td>
<td>378.5</td>
<td>-1.2</td>
<td>3.5</td>
<td>4.0</td>
<td>5.0</td>
</tr>
<tr>
<td>Austria</td>
<td>€309.5</td>
<td>226.6</td>
<td>-2.4</td>
<td>3.5</td>
<td>3.5</td>
<td>4.0</td>
</tr>
<tr>
<td>Malta</td>
<td>€6.5</td>
<td>4.9</td>
<td>0.0</td>
<td>3.5</td>
<td>4.5</td>
<td>5.5</td>
</tr>
</tbody>
</table>

source: German Council of Economic Experts

![Maximum volume of the European Redemption Fund (2018)¹](source)

1) Own calculations; considering payments already made by that point

source: German Council of Economic Experts
One criticism of this policy is the loss of autonomy that will ensue from the mandatory ratification of the Fiscal Compact into the constitution of the participating countries. While this does represent some loss of autonomy, it seems the euro zone has passed the point when it can afford to make all of its own fiscal policy when monetary policy is dictated by the charter of the ECB. While we do amend the ERP to require all members of the euro zone to participate, which represents a further breach of autonomy, we also amend the pact so that countries can control their deficit, so long as debt remains below 60%.

Political Support

Since it’s initial proposal in Oct 2011, the European Redemption Pact has gained support. While Merkel and her party opposed the plan and has only slightly warmed to it over the last year (Bloomberg 25/5/2012), strong support comes from France and many others (NY Times 29/10/2012).

Works Cited


