At the extraordinary EU Council of 21 July European leaders have to accomplish a triple-mission. First, they should pave the way to restoring solvency in Greece by initiating debt reduction. Softening the Greek debt burden implies i) reducing the interest rate on official lending, ii) requesting from the EFSF support for an immediate bond buy-back programme, and iii) asking the ESRB for an immediate evaluation of the risks to financial stability involved in a future restructuring of the sovereign debts in the euro area.

Second, they should promote immediate growth-enhancing measures to be financed through unused EU structural funds and EIB loans (€16bn). The available funds shall be used to i) raise the quality of higher education, ii) finance wage subsidies in manufacturing and tourism so as to generate an internal devaluation at contained domestic-demand costs; and ii) create research laboratories (i.e. lighthouse innovation projects) that would support an upgrading of the Greek value chain.

Third, they should address risks to financial stability in the euro zone by breaking the vicious circle between 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 but of course more ambitious reforms are necessary down the road.

*The authors would like to thank colleagues inside and outside of Bruegel for very helpful comments and suggestions.
The Greek crisis is only one dimension of a broader set of issues the leaders of the euro area need to address urgently to stop the escalation of market turbulence. But it has become in the eyes of markets participants, and the citizens, the litmus test of the EU’s ability to solve its problems. By getting their acts together on Greece, the euro area would demonstrate a broader ability to address the problems assailing Europe.

The extraordinary meeting of European leaders on 21 July should map out the European strategy for responding to this crisis, starting with an approach to restoring the country’s solvency. Responses to immediate concerns about sovereign debt have to be combined with a credible growth strategy. Finally, leaders should address broader systemic euro-area fragilities.

1. Pave the way toward restoring Greek solvency

Greece is insolvent. Any policy action 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 on its own under any reasonable scenario. To predicate the success of Europe’s Greek strategy on the opposite hypothesis is irresponsible because it makes success hinge on a series of low-probability developments.¹ This would be true of any country grappling with excessive debt but applies even more to a member of monetary union that has to undergo an internal devaluation to restore competitiveness and foster sustainable growth.

The euro area needs a robust strategy to deal with Greece and this is bound to require a significant debt reduction. We estimate that a viable solution should result in reducing the net present value (NPV) of future debt obligations by at least one-third. The European leaders should recognise this reality. At the same time leaders, the European institutions, and financial markets as well are still unprepared for a significant debt restructuring at the expense of private investors. Preparatory works for ensuring the recapitalisation of banks heavily exposed to sovereign risk – first and foremost the Greek banks – and for mitigating threats to financial stability are in infancy. Whilst more informative and credible than those conducted a year ago, the recent stress tests by the European Banking Authority have not helped in this regard because sovereign default has not been considered a possibility. Moreover, a restructuring at this stage, especially if hastily prepared, could lead to further increases of spreads in other euro area countries. Finally, the ECB 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, the last thing the euro area needs is a precipitous and disorderly default. European leaders have no choice but to postpone the eventual launch of a restructuring process. This would also give the necessary time to enact much needed reforms in other countries. For example, the Spanish government has committed to consolidate its savings banks (Cajas) by September; and measures to strengthen the fiscal framework and improve the functioning of labour markets are part of the necessary agenda.

This state of affairs implies that what can be expected from euro-area governments is that they agree on additional official finance for Greece, for a long enough period to cover financing needs until the country is able to borrow on financial markets – the so-called second programme. At the 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 not be acceptable for the Greeks and for this reason, it could further undermine

¹ See the evidence in Darvas, Pisani-Ferry and Sapir (2011) and, for an update, Darvas (2011).
political stability. Euro area leaders could therefore agree on a significant reduction of the interest rate charged on the 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 EFSF itself is borrowing on the market, plus a small margin to cover the operational cost. Indeed other non-euro area countries under assistance (Hungary, Latvia, and Romania) receive lending at European borrowing rates plus a small operational surcharge. But lowering of 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, that 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 other two programme countries of the euro area (Ireland and Portugal). Third, the German government will have to clear ex-ante whether such a step would be compatible with the German constitutional court. So far, it has been an important argument for the German government that the provided assistance is delivered at a significant fee rendering it compatible with the “no-bail-out clause.” Fourth, taxpayers could legitimately question the provision of subsidised loans to Greece, especially in the absence of private-sector involvement.

This is a justification to seek political agreement that any future cost resulting from assistance to Greece (arising from a subsidy component of loans provision or eventual debt forgiveness) would be entirely covered by an exceptional levy on financial institutions. It could be proportionally reduced for institutions taking part in domestic or cross-border merger and acquisition transactions with the view of recapitalising fragile institutions.

Furthermore, any new financing programme implies a reduction in the exposure of the financial system to Greece, thereby shifting more and more 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.

Private sector involvement is now more widely recognised as a necessary part of a comprehensive solution. 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 solvency.

The European leaders should start applying moral suasion to create the necessary incentives to private-sector participation. To signal the need for debt reduction, and support for it, the leaders this week should request from the EFSF support for an immediate bond buy-back programme. The programme, of limited size (say, €50bn), would crystallise immediate losses and achieve some limited debt reduction (of about 10% of GDP at most). By itself, such a move would not suffice to change the debt equation materially but it 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 ESM) package to include the possibility of purchases on the secondary market.

Notwithstanding these steps, a comprehensive debt restructuring 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 the sovereign debts in the euro area and proposals for mitigating
Summing up, the European leaders this week are not in a position to take bold decisions. But they can set new directions in the management of the Greek debt crisis by:

- 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 the sovereign debts in the euro area, and proposals for mitigating them.

2. **Devise a growth strategy**

To secure the solvency of Greece, debt relief is only a temporary fix. More fundamentally, a serious programme of growth revival 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 higher than their core Tier-1 capital. In these conditions Greek banks are cut off from access to market liquidity and they are subject to deposit withdrawals (IMF projects deposits at end-June 2011 to be 15 per cent 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 per cent in 2011Q1, contributing in a major way to GDP decline (-6 per cent 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. 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% in 2008. Competitiveness has improved since thanks to nominal wage adjustment (-6 per cent yoy 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 responses should be brought to these challenges. To strengthen the banks, money in the current EU/IMF programmes earmarked for the banking system needs to be used and possibly topped-up to ensure the Greek banking system is sufficiently capitalized to provide credit. At the same time the EU should encourage take-over of Greek banks by foreign banks. To support domestic demand and give Greece a chance

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\(^2\) See Wolff (2011)

\(^3\) See Ruscher and Wolff [2010].

\(^4\) European Commission [2010b].
to grow, the short term pace of fiscal adjustment should be slowed down. But immediate fixes will not be
even.
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 sources of demand.
The European leaders should therefore provide support to a five-plank economic revival strategy.

a) A Greek Economic Revival Fund. For a growth revival strategy there is no scarcity of financial means. Under
the current multiannual financial framework 2007-2013 Greece has still more than €12bn in unused funds,
in other words more than 5% of GDP. Moreover, the available funds may be used to leverage EIB loans for which
Greece has applied relatively less than other Southern countries.5 Assuming one third of the unused funds is
used to finance EIB-like projects in energy, transport, telecommunications and loans from the EIB finance 50%
of the project’s total costs, as standard, the potential size of the growth fund available over the 2011-2013
period would increase to €16bn or about 7% 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.

An early disbursement of the funds that have been already allocated to Greece at the beginning of the
financial framework needs to be secured. The Commission should launch a proposal for special legislation to
realloccate to a Greek Economic Revival Fund uncommitted Structural and Cohesion funds earmarked for
Greece within the framework 2007-2013 financial perspective. This Fund should be used to support the
growth and competitiveness components of the EU-IMF programme and priorities for it should be decided
within the framework of this programme. Legislation to this end should be passed urgently by the Council and
the Parliament, so that it is effective before end-year.6

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 has eventually fuelled construction booms. The co-funding mechanism has created political rents and
also outright corruption and nepotism. Future disbursements will therefore have to address the issue of the
governance of funds as well as the destination of funds. In the following, we suggest four specific
destinations of funds, which should each be allocated €4bn over the 2011-2013 period.

b) A programme to increase the quality of higher education. Prior to the crisis, the quality of education was
identified as an important impediment to Greek growth. There is now a serious risk that budgetary adjustment
will result in further deteriorating the quality of the higher education system. €4bn from should be allocated
to funding 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 it was not subject to the same dramatic downsizing it went
through in the rest of the euro-zone over the last decade. Nevertheless, European Commission research has

5 Marzinotto [2011].
6 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 (EIF) whereby structural funds are paid
up-front to support small and medium enterprises (SMEs) and their most innovative projects. The funds are typically
collected under 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.
shown that a large fraction of Greek corporations have already some export basis. As regards 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.

Priority should thus be devoted to reducing labour costs in the tradable sector. 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 can 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 €11bn. €4bn from the Economic Revival Fund should be earmarked for temporary wage subsidies in these sectors, to be introduced on 1st January 2012 and phased out in 2013-2015. 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 of these wage subsidies might more specifically target R&D intensive sectors to secure a higher growth potential, revert the brain drain, help attract Greek nationals leaving abroad, and prepare the ground for an upgrading of value chains.

In order to avoid wage cost reduction 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 together with national competition authorities use all available instruments to foster competition and reduce rents. For example, reducing administrative burdens on firms to allow entry by lowering legal requirements would be a first important step in the direction of changing the domestic competitive environment. Indeed, these types of measures have also the merit of having quite immediate strong macroeconomic effect.

d) Enterprise support to foster the upgrading of production and exports. Economies grow by upgrading the products they already produce and by introducing the production of similar products. Given a certain set of knowhow, it is easier for them to upgrade to closer products than to more distant ones. In the case of Greece, there is a high potential for upgrading. Hausmann (2011) finds that agricultural machinery and appliances, metal forming machine tools and dairy machinery as well as electric equipment for internal combustion engines and special textile products are natural products for increasing the Greek production space. For the process to succeed it is necessary for the most innovative firms and for small and medium start-ups to have access to finance.

This is even more urgent in a situation where weakened banks may restrict access to credit. €4bn from the Economic Revival Fund should be re-affected to supporting credit for SMEs and providing capital for entry in the production of new products. Public support should be provided on a competitive basis to sectors that have the highest potential of fostering efficiency.

e) "Lighthouse" innovation projects. A larger variety of products and high value added production needs to be targeted if Greece wishes to substantially increase exports and income. However, such developments to

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7 European Commission [2010a].
8 If the activities in R&D sectors are conducted by SMEs, subsidies may be well financed by structural funds under the Jeremie programme (e.g. €2bn) and thus be implemented almost immediately and in a flexible setting.
10 The EIB provides indeed credit lines to national financial intermediaries to finance these types of initiatives or indeed structural funds may be channeled through under the umbrella of the Jeremie programme.
11 The case for such intervention is made in Aghion (2011).
new technological levels are unlikely. At the same time, exactly those quantum leaps in technological development are most conducive to boosting exports and growth. €4bn should be 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 combining centres of academic excellence with special business zones that allow for technological spin-off. Relying on local universities only will however not be enough to foster synergies. Instead, European top-notch research institutions (Oxford, Max-Planck society, etc.) 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 biotechnology or green growth 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 underutilized.

This five-pillar 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 tradables sector. Absent 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 technical change. Hence, 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 an efficient state apparatus are key determinants of innovation and investment. The European funds should therefore be conditioned 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 is a necessary and decisive step towards an 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 reforms of the euro area and devise mechanisms that allow preventing contagion. The recent attacks on Italy and Spain have unveiled an 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 across 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, drawn on the basis of the recent stress test results, provides a good indication of where each national banking system stands in terms of vulnerability. On the vertical axis is the ratio of domestic banks’

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exposure to their own country’s public debt to core Tier 1 capital. This ratio is indicative of the potential repercussions of a country’s sovereign debt crisis on its own banks. On the horizontal axis is the ratio of 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: Banking-sector exposure to the domestic sovereign in the EU

Source: EBA stress tests, Bruegel calculations
What the graph indicates is that a major fragility of the euro area comes from the fact that in many countries banks are excessively exposed to threats to the solvency of their own sovereign. When this solvency is called into question, banks are immediately affected because of their direct exposure and because 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. In turn, this further weakens the situation of the sovereign, because of expectations of bank rescue costs.

This lethal 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-zone national deposit insurance schemes. Such a measure, however, would also require significantly stepping up supervisory powers of the centre, to align incentives and avoid moral hazard. The European Banking Authority could be given such additional power. By the same token banks should be better protected against the failure of their sovereigns, through diversification of their bond portfolio. 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.

In the same way they initiated reforms of the euro-area surveillance system in 2009-2010, the leaders should call upon the President of the European Council and the European Commission to prepare proposals in this field.

Conclusion

The leaders of the euro area cannot be expected to solve lingering problems by the stroke of a pen. They cannot be expected either to find unanimous agreement in fields where 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 down the road will be necessary.

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13 See Véron [2011].
14 Pisani-Ferry [2011]
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