SUERF
THE EUROPEAN MONEY AND FINANCE FORUM

newsletter
July 2012

The Interaction of Political, Fiscal and Financial Stability: Lessons from the Crisis

Main findings from the 2012 SUERF Annual Lecture and joint SUERF/OeNB Workshop in Vienna on 18 June 2012

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Pictures (l-r): Governor Ewald Nowotny (OeNB), Governor András Simor (MNB), first panel session.

The current financial, economic and fiscal crisis is among other things characterised by complex interrelations between financial, fiscal, macroeconomic and political instability. One instability breeds another, with feedback loops generating self-reinforcing adverse cycles: The financial crisis triggered the "Great Recession". Countermeasures by governments – to save banks and bolster up aggregate demand – ultimately jeopardized fiscal sustainability and bred the fiscal crisis. The latter in turn destabilised sovereign bond markets and banking systems in several countries. Political instability resulted from the substantial fiscal consolidations forced upon governments in the light of threatening or actual loss of access to financial market financing, and the accompanying deep recessions and sharp increase in unemployment. Political instability in turn further erodes economic and financial market confidence, thus worsening short and long-term economic and fiscal prospects, and further aggravating financial instability. In the EU and more specifically the Euro Area, multiple channels of spillovers and contagion turn the problems from purely national phenomena to ones of EU-wide and ultimately even global scope. Thus, apart from national political processes, Euro Area and EU-wide economic governance is now being criticized for not addressing reform needs decisively, thus prolonging and deepening the cycle of instability.

Contents:

Vienna Conference Report 1
New SUERF Study 7
Copenhagen Conference Programme 8
News from Council 9
Book Review 10
New SUERF Members 12
Future Events 12

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The workshop took place just a few days ahead of the European Council of 28/29 June 2012. At that Summit, European leaders announced a number of important new measures, which address some of the above problems and may be seen as a step towards the introduction of "circuit breakers" between the above three instabilities.

Ewald Nowotny, Governor, Oesterreichische Nationalbank, opened the event. He noted that central banks face extreme challenges in the current crisis, given their pivotal position at the nexus between the financial system, the macro economy and politics. The economic literature and experience clearly identify political stability as a pre-requisite for economic growth and prosperity. Thus, crisis management and longer-term reforms should keep political stability in mind. The current crisis in Europe is also a general crisis of confidence. Lack of confidence among financial market participants leads to market dysfunctionality, open or silent bank runs, capital flight and general financial instability. In the real economy, lack of confidence deepens downturns, leading to severe and prolonged recessions. Lack of confidence in the sustainability of government finances has blocked several states' access to market funding. The large number of players in the EU policy-making process and the highly uncertain consequences of various courses of action (e.g. externalities, complex incentive structure) complicate the finding of solutions. In the light of the inability of existing political structures to react quickly and decisively, monetary policy was forced to intervene. Eurosystem action managed on several occasions to calm markets – but not completely and permanently. Monetary and liquidity policies can only buy time but cannot solve deep-rooted structural deficiencies and unsustainable fiscal and external positions of several Euro Area countries' economies. Remedies should refrain from backward-looking blaming and shaming and should rather look forward and take the necessary actions conducive to solving current and prospective immediate problems. Rescue costs may be small compared to the alternative of a country exiting the Euro Area or a halt to the European integration process. The "cost of non-Europe" would reach far beyond the economic sphere: after all, Europe is a historical political, cultural and peace project. So, given conditions are met, help to suffering countries is indispensable. Economists and policy makers must draw the lessons from economic history: The Great Depression showed where a single-minded concentration on austerity may lead. Central banks around the world are aware of these risks. In searching for solutions, we must be open-minded and flexible. In this vein, EU institutional arrangements may be adjusted, in the direction of a banking and fiscal union. The Eurosystem stands ready to accompany the adjustment process but at the same time there is no doubt that central banks have stretched their possibilities very far already. Monetary policy cannot substitute for missing decisions in other policy areas. Thus, addressing the political dimension of the confidence crisis by institutional change will be key to solving the economic, fiscal and financial crisis.

Urs Birchler, SUERF President and Professor, University of Zurich, thanked the OeNB for hosting the event and for the fruitful ongoing co-operation between SUERF and the OeNB.

The **2012 SUERF Annual Lecture** was given by **András Simor**, Governor, Magyar Nemzeti Bank, on "The Interaction of Political, Fiscal & Financial Stability: Lessons from the Crisis". Politics has its own logic of political feasibility and popularity, which is sometimes orthogonal to economic reasoning. Simor illustrated this proposition using the current European situation and the one in Hungary. In Europe, political feasibility often acts as a binding constraint to many economically rational ideas put forward for containing the debt crisis. The very design of EMU was a political compromise between pushing ahead European integration, while minimising the transfer of sovereignty (political, fiscal, banking supervision) to the European level. In

fact, EMU was designed more as a currency board than a truly unified single economic and monetary area. During its first decade of existence, EMU enjoyed a safe-haven status, concealing the fault lines. The fiscal rules were incentive incompatible and circumvented. Real exchange rate misalignments and current account imbalances accumulated. Cheap and unlimited finance created credit booms, public and private debt overhangs and asset price bubbles. With the outbreak of the crisis, national bond markets – like currency markets two decades earlier in the EMS – became the target of speculative attacks. Negative feedback loops between financial, macroeconomic, fiscal and political instability created vicious circles. The challenge is to fix the flawed architecture of EMU, while it is continuously shaken by devastating financial turmoil. The reform process so far has been characterised by several rounds of incremental institutional changes, each of which brought only temporary relief. Bolder steps are required: 1) making fiscal rules incentive compatible, enforceable and more functional; 2) ensuring that the excessive imbalances procedure really "bites"; 3) a large-scale of lender of last resort for national governments, supranational bank resolution and deposit insurance; however, introducing risk-sharing mechanisms at a time of immediate pay-outs, when the contributing and recipient countries are more or less predefined, is difficult; 4) as a corollary to more risk-sharing, supervision and control must be transferred to the supranational level. An important constraint on more risk sharing is the risk that large (potential) liabilities may endanger contributor countries' credit ratings. Eurobonds are only feasible if discussed as part of a complex set of rights and responsibilities compatible with enhanced risk-sharing. The Eurosystem has been forced to intervene heavily to avoid a meltdown of the financial system; however, the ECB cannot and should not take over politicians' tasks. Central banks cannot effectively tackle solvency issues, which, if treated merely by the addition of liquidity, postpone the real solution and enlarge the problem itself.

The Hungarian experience of economic developments and reforms over the past few years offers important lessons for other countries and Europe at large. When the economy becomes stuck in stagnation and reform fatigue grows, disappointed politicians may turn towards unchartered waters to obtain quick solutions. Measures may be abused and get ideological distortions in the sense that, in order to maintain electoral support, the primary burden of the adjustment is shifted to "non-voting" economic agents, sometimes accompanied by offensive rhetoric, with hugely detrimental consequences for the investment climate in the country. A first example in Hungary was "fiscal devaluation": in order to achieve a reduction in unit labour costs, the tax burden was shifted from labour to excise and value added taxes as well as new sectorial business taxes. However, as the measures did not bring the hoped for result of economic recovery, "crisis taxes" are being transformed into permanent ones. Uncertainty arising from the unorthodox, distortive "Robin Hood" taxes significantly contributed to deteriorating investment sentiment in Hungary. The second example is measures to address the problems arising from foreign exchange loans. By shifting most of the burden to banks and their foreign owners and by targeting middle class borrowers rather than nonperforming borrowers, no improvement in banks' credit portfolio quality actually occurred, while banks faced large capital losses, which together prevented any improvement in lending from happening.

Session 1, chaired by **Peter Mooslechner**, Director Oesterreichische Nationalbank, highlighted various aspects of the political economy of sovereign debt crises.

Iain Begg, Professor, London School of Economics and Political Sciences, started out by arguing that there are vastly different analyses of the reasons for the crisis. Some argue that the whole set up of EMU was misconceived in the first place to work in bad times. Others point to market failure ahead of the crisis, when markets

under-priced risk (obviously not believing the no bail out clause). Third, many argue that political solutions are coming forward much too slowly; apparently, the economic governance framework for EMU did not consider crises. Why did we not anticipate the build-up of bubbles and the ensuing crisis? The usual sequence of events during crises is firstly, denial, secondly, reluctance to act, thirdly, a vain search for the magic bullet and fourthly, panic and possible over-reaction. Solutions get further complicated by ambiguity of mandates and responsibilities, most obviously about the role of central banks. The usual result is resentment and populism on all sides. The current phase is characterised by blaming and shaming: Greece blames the other member states, politicians and media blame the banks, ordinary citizens blame tax evaders, national actors leave the burden to act to the ECB. There are of games at many levels going on. National interests, such as elections and constitutional constraints, overlap with power plays and blame shifting between the national and supranational levels as well as among supranational players. Burden-shifting ranges from "dictatorship of the creditors" to "blackmailing by the debtors". The success of structural reforms crucially hinges on public support for such measures. Crisis management is further complicated by the different speed of understandably slow democratic decision processes and very fast and abrupt financial market reactions. The Euro Area's political decisions are characterised by deeply flawed communication with markets, e.g. the announcement of private sector involvement, which severely aggravated the crisis. Despite extensive and rapid EU governance reform, there is the notion of dithering and indecision. While the future brings a number of challenges and obstacles for euro area crisis management, it must be recognized that a lot of important progress is happening: the governance framework is moving forward substantially, Germany's tough stance is being softened up both internally and by elections in important partner countries, and structural reforms are showing progress. All in all, time has been bought in the euro area by ECB actions, the reforms to economic governance achieved are substantial, but a clearer roadmap is still needed.

Andrew Bosomworth, Head of PIMCO Portfolio Management in Germany, shed light on the political economy of debt crises from the perspective of a financial investor. Investors are interested both in the return of, and the return on, capital. The former currently dominates investment decisions. In this situation, the status quo, centralised monetary policy and decentralized fiscal policies, does not work. The fact that junk bond corporations from core countries can currently finance themselves far more cheaply than investment grade companies from peripheral companies is testimony to considerable market failure resulting from individually rational, but collectively suboptimal decisions. Historic monetary unions on average lasted for 50 years; they broke up due to suboptimal fiscal policies by individual participants. Bond investors currently face a bimodal distribution of future economic outcomes in the euro: EMU break-up or shrinkage, on the one hand, and proper fiscal and political union, on the other. The near-nil yield on German bunds reflects a premium to be paid for the possibility of EMU break-up and revaluation of a future German currency. Currently, small initial events can develop into very large and spread-out consequences; developments in Greece are an example of potential "butterfly effects", given the strong tendency of financial markets to overshoot. Thus, any solutions need to include the creation of trusts among financial markets. The only reasonable way forward for Europe is deeper integration. To achieve a quantum leap in political and fiscal union, this needs to happen on Germany's terms, i.e. the EU centre needs to be able to control fiscal positions in individual countries, and peripheral countries need to achieve a quantum leap in making their economies more efficient and competitive. Otherwise, for some countries, the least worst situation might be to revert to their own legacy currencies. In the end, investors cannot base

their decisions on hope, but need to rely on judgement of likely outcomes. Investors need a coherent roadmap for further reform to gain the necessary confidence to invest in European peripheral markets.

Ugo Panizza, Chief of the Debt and Finance Analysis Unit in the Division on Globalization and Development Strategies of UNCTAD, offered his views on the politics of debt and debt crises. In tranquil times, politics suffers under a deficit and debt bias because debt allows postponing difficult decisions but also because it may tie the hands of later politicians. Solutions to this are fiscal institutions, such as smart budgetary rules and procedures as well as transparency. But low debt is not enough to avoid fiscal problems, as the very high sovereign bond yields of Spain – with its very low pre-crisis public debt – illustrates. Divergence of price developments and competitiveness was equally important for the crisis. Once a state becomes insolvent, governments often gamble for redemption and delay default. This is problematic because it prolongs the economic crisis and weakens the recovery. Sovereign default packages often come with requests for fiscal consolidation, limited costs for creditors, and interest rates above the opportunity costs of funds. This is not optimal, particularly if the cause of the crisis in the first place was not fiscal. Furthermore, fiscal sustainability is a long-term concept, short-term restrictive fiscal policies may be counterproductive because they may worsen the crisis and may be reversed as soon as the situation improves and the country no longer needs international assistance. Rather, success requires addressing the political distortions that led to the unsustainable long-term policy stance. Contrary to common belief, there is no evidence on a causal negative relationship between public debt levels and economic growth. Limiting the size of rescue packages and charging high interest may reduce the probability of success. In this context, Panizza agreed with Governor Nowotny in that moral hazard is grossly overrated. There is currently no tool kit for the resolution of sovereign debt crises. Therefore, debt renegotiations take too long, their outcome is uncertain and, in general, they do not restore debt sustainability. A structural mechanism that certifies unavoidable (as opposed to strategic, opportunistic) defaults could speed up defaults, thus avoiding unnecessary suffering and, by increasing recovery values, reduce borrowing costs.

The workshop was concluded by Session 2, which was chaired by **Ernest Gnan**, SUERF Secretary General and Head, Economic Analysis Division, Oesterreichische Nationalbank, and raised the issue of what is special about the debt crisis in the euro area.

Elga Bartsch, Morgan Stanley Chief European Economist, noted that debt levels are too high in many countries around the world, so Europe is not special in this respect. It is not special either in the sense that political decisions are complicated – also in the US, political consensus is breaking down. Europe is different in the sense there is not yet a banking union, but the key difference is that in the Euro Area, contrary to the US, there is no lender of last resort for sovereign bond investors. Therefore, contrary to the US and the UK, where investors apparently assume the respective central bank would in case of severe economic distress monetize debt, in the Euro Area no such reinsurance exists, and thus government bonds are not risk-free assets. The absence of credit risk of governments is central to Keynesian policies, since under this condition, in a downturn or crisis, governments can borrow cheaply, and thus inject demand into the economy as well as rescue banking systems. Since European sovereign bonds have lost or are about to lose their risk-free status, Keynesian policies are no longer feasible. Many European countries now borrow like emerging markets, which cannot borrow in their own currencies. The emerging market crisis showed that, as a result of portfolio managers' incentives, markets overpriced risk dramatically and tended to become illiquid. To restore the risk-free asset status of Euro Area government bonds, a solution might be

to grant the ESM the status of a bank with access to ECB refinancing. By introducing a two-tier bond market (e.g. blue and red bonds, debt redemption fund etc.), government default would be greatly facilitated. This is worrisome in the sense that it could further destabilise market expectations. At the same time, senior government tranches (e.g. blue bonds) might enjoy lender of last resort protection.

Financial markets have a blind spot in anticipating inflation correctly, therefore they currently overprice US and UK bonds. It is encouraging that in Europe there is awareness of the need for change. As a result, in two to three years' time, Europe might emerge much stronger than expected by many.

Lex Hoogduin, Professor, University of Amsterdam, noted that fiscal positions and competitiveness had been deteriorating in several Euro Area countries (Greece, Portugal, Italy, Belgium and France) for quite a while. In Ireland and Spain, sizable real-estate bubbles had built up and burst. This has become a financial stability issue for the Euro Area and globally for three reasons: deep financial integration; private sector involvement; and contagion. The crisis has exposed problems in the governance of the euro area and has created unsustainable conditions for the euro and the ECB. The Maastricht convergence criteria for euro area participation were violated, and countries are drifting further apart in the crisis. As a result, the conditions for having a single currency and monetary policy are not met. Therefore, the ECB can no longer function as a central bank for a single currency. What is needed now is therefore a renewed convergence process. The crisis also has shown that political integration is insufficient, there is too little support to take the decisions required to get problems under control and to treat them as a common problem. This frightens markets and puts the entire project at risk. Looking forward, a European redemption fund will be needed. There needs to be bold restructuring of the European banking sector, in tandem with addressing excessive government debt and deficits. To facilitate economic convergence towards the best performing countries, the Eurosystem's definition of price stability should be adjusted downwards, in order to allow the necessary wage and price downward adjustment in the problem countries to take place, while avoiding higher inflation and the build-up of financial imbalances in Germany. Only once the mess has been cleaned up, can the no-bail out rule, which has been violated, be credibly restored again. Banking supervision needs to be centralised, given the high degree of financial integration in the EU and the Euro Area. All these measures do not require political or fiscal union, which would not meet public support now. Only once the provisions of the Maastricht Treaty are fully complied with and Euro Area countries have developed the necessary understanding for the common good, should a European Finance Minister, with substantial power and budget, who would be accountable to the European Parliament, finally be installed.

Moritz Kraemer, Managing Director and Head of the Sovereign Ratings Group for Europe, Middle East and Africa at Standard and Poor's argued that in many respects current developments in European crisis countries very much resemble traditional current account crises; the only difference is that it happens within a monetary union. Outside EMU, Greece could hardly have run a current account deficit of 14% of GDP backed up by an export base of just 20% of GDP. The euro created a new paradigm for policy makers in the sense that traditional limits to sustainable policies no longer seemed to apply, as all governments and countries enjoyed low financing costs. With the benefit of hindsight, however, we know that debt bearing capacity did not increase by nearly as much as initially thought. This misjudgement was prompted by the fact that exchange rates among individual euro area countries, which might have reacted earlier, no longer existed; also bond markets did not react for a very long time; and with the Stability and Growth Pact made more "intelligent" and "flexible" in 2005,

there were no signals coming from Brussels any more either. When Standard & Poor's started downgrading the peripheral countries in 2004, this was not received well by countries, which were banking on further convergence. But convergence is no law of nature. All in all, markets, and also credit rating agencies, underestimated credit risk during the boom. What sets the Euro Area debt crisis apart is the absolute size of government debt involved. Currently the international environment does not facilitate adjustment through exports. External imbalances within the euro area were for a long time financed through cross-border capital flows; with the outbreak of the crisis, these flows have suddenly stopped or been reverted. Liquidity support and Target2 by the Eurosystem were very effective in cushioning immediate effects of capital flow stop or reversal but they are no permanent solution. Despite difficult political decision-making processes also in countries such as the US, the problem is further accentuated in Europe and the Euro Area: there is "always an election somewhere". Ratings always have to take the political situation and feasibility of reform measures into account, both at the level of individual countries and of the euro area as a whole. The fiscal problems in Ireland and Spain were the result of external imbalances; in this sense the Fiscal Compact does not solve the problem for them. Bubbles led to massive misperceptions of potential output and output gaps. What we need is a rebalancing and growth agenda accompanying fiscal consolidation. Europe is good at producing long-term visions. Regarding short-term crisis solution, the ECB's non-traditional measures were useful to buy time, but now political decision-makers need to make us of this time. Governments that have made their countries dependent on funding by creditors, have three options: first, finding new creditors, which is difficult or impossible now; second, official aid, which has its own (e.g. political) costs and limits as well; and third, default. If on does not want to go for the last option, one has to bring in private investors back, and one has to think how to make this attractive. Subordinating senior bond holders, as is often done in the context of public and international rescue programs, is not useful in this respect. We have had the feeling already several times during the current crisis that the "end game" is near, but Europe has shown much stronger resilience than previously thought. Credit risk is still biased to the downside in market prices, rating agencies are much more positive than suggested by market prices.

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Taken together, there appeared to be a growing consensus on the underlying mechanisms and problems at work, and on the set of policy steps needed to solve the Euro Area debt crisis. Indeed, a number of ideas raised in the presentations and discussions were mirrored in the decisions of the European Council a few days later on 28/29 June 2012. As always with SUERF, the active dialogue between academia, market practitioners and the policy community proved to be fruitful, thought-provoking and productive. The conference proceedings will be published as a SUERF Study later in the year. SUERF wishes to express special thanks to the Oesterreichische Nationalbank for hosting and generously supporting the event.

New *SUERF Study*

2012/3 Future Risks and Fragilities for Financial Stability, edited by David Llewellyn and Richard Reid, Vienna, June 2012, ISBN 978-3-902109-63-7 – **www.suerf.org/ss20123**