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

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SUERF – The European Money and Finance Forum
Vienna 2013

SUERF Study 2013/1

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Keywords: Financial stability, sovereign bonds, political stability, Euro Area, contagion, spillovers, crisis management, monetary policy, liquidity, fiscal consolidation, supervision, governance, banking union, sovereign ratings

JEL Codes: E5, E58, E62, E63, F34, G15, G2

Vienna: SUERF (SUERF Studies: 2013/1) – February 2013

ISBN: 978-3-902109-66-8

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1. Introduction

Ernest Gnan

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 has been criticized for not addressing reform needs decisively, thus prolonging and deepening the cycle of instability.

The purpose of the Annual Lecture and the Workshop was to improve our understanding of these multiple and complex interrelations, and to identify possible circuit-breakers and other remedies to counter these developments, re-establish stability in the countries affected, the Euro Area and European Union at large, and thus to pave the way for economic recovery over the medium run.

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, including important steps towards a European Banking Union, 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. This, together with the ECB's announcement in late-summer of 2012 of programme-conditional government bond purchases under the newly established Outright Monetary Transactions (OMT) has led to a significant easing of sovereign risk spreads in the troubled Euro Area countries, thus emphasising the close relationship between financial market developments and firm public policy (or perceived commitment towards, and expectations about, them).

Ewald Nowotny, Governor, Oesterreichische Nationalbank, opened the event; his remarks appear in Chapter 2 of this Study. 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 so far 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 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 and Financial Stability: Lessons from the Crisis*", with his speech appearing as Chapter 3 of this Study. 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 sectoral 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, whose remarks are summarised in Chapter 4, 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 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, whose remarks are summarised in Chapter 5, 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 trust 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, Professor of Economics, Pictet Chair in Finance and Development, the Graduate Institute, Geneva, offered his views, published in Chapter 6, 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. 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, Chief European Economist, Morgan Stanley, whose remarks appear in chapter 7, 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 that 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[1], 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

[1] No written paper is available for this intervention.

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[2] 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 the 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

2 In his written contribution in Chapter 8 of this volume, Moritz Kraemer focusses on the effect of austerity on sovereign ratings.

reverted. Liquidity support and TARGET2 by the Eurosystem were very effective in cushioning immediate effects of capital flow stops or reversals 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 one does not want to go for the last option, one has to bring private investors back in, 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, and of the ECB Governing Council as regards the announcement in late-summer 2012 of OMT sovereign bond purchases. As always with SUERF, the active dialogue between academia, market practitioners and the policy community proved to be fruitful, thought-provoking and productive. SUERF wishes to express special thanks to the Oesterreichische Nationalbank for hosting and generously supporting the event.

2. Opening Address

Ewald Nowotny

Ladies and gentlemen,

On behalf of the Oesterreichische Nationalbank it is a great pleasure and honour for me to welcome you to this SUERF/OeNB Workshop and the 2012 SUERF Annual Lecture.

In particular, I would like to welcome my friend and colleague András Simor, Governor of the Hungarian Central Bank and this year's SUERF Annual Lecturer.

Dear András, we all know about the challenges central banks – and especially you as the Governor of the Hungarian central bank – are facing at the current time. The workload and meeting schedule is often overwhelming. All the more, we appreciate your time and effort to have come to Vienna today in order to address this audience.

It is also a great pleasure to welcome the distinguished speakers of this workshop, high-level representatives from finance, academia and international institutions.

As you may know, the OeNB actively supports SUERF by hosting its Secretariat and by providing SUERF's Secretary General, Ernest Gnan. The reason is that we very much appreciate SUERF's mission to provide a forum which "brings together bankers and financial practitioners, central bankers and supervisors, as well as academics for the analysis and mutual understanding of monetary and financial issues". This is very much what central banks have to do all the time. The financial, economic and fiscal crisis has highlighted this even more.

2.1. Theme of Annual Lecture/Workshop

This year's workshop and Annual Lecture deal with "The interaction of political, fiscal and financial stability: lessons from the crisis", a nexus which is at the very core of Europe's current problems. The financial crisis triggered the deterioration of economic activity. These developments further led to a fiscal crisis. The fiscal crisis in turn destabilised banking systems and financial markets at large. Political instability is both a result of the economic aspects of the crisis and a cause, as it may further erode economic and financial market confidence, thus deepening the recession and fiscal difficulties, and deepening financial instability. Vicious circles can be the result.

2.2. The Role of Political Stability

Economic literature (work by Sala-i-Martin and others) and experience from development economics clearly identify political stability and reliable political players as a pre-requisite for economic growth and prosperity. While political stability was not an issue for industrialized European countries for half a century, the harsh financial and economic distortions, which forced substantial austerity packages and partly created large changes in the income distribution for the countries under international rescue programmes, brought political stability concerns back on the table. The recent developments in Greece show that internal political pressure and the short horizon of legislation periods have the potential to cause substantial time inconsistency problems. Thus, any prescribed or recommended structural changes or economic stimulus packages have to keep political stability in mind. Some already agreed and partly implemented programs may have taken this aspect not seriously enough.

2.3. The Current Crisis is above all also a Crisis of Confidence

The current crisis in Europe is also a general crisis of confidence: in banks and financial markets, in economic policy institutions, in the reliability and decision-making capacity of governments, in democratic opinion-shaping processes, in the stability of money, in the reliability of property rights, in the economics profession – and we could continue the list on and on. The confidence crisis goes along the lines of Keynesian ‘Animal Spirits’ in various dimensions.

Let me explore the theme of confidence crisis a little bit deeper for the three areas of instability identified in the title of this workshop.

The lack of confidence among financial market participants including banks led to blockages and severe dysfunctionality in the interbank lending markets and caused financial instability.

The confidence crisis spread to the real economy and caused uncertainty in expectations about future economic development which contributed to the Great Recession.

The Great Recession and the costs of rescuing financial systems put a big toll on public finances, which in some cases where in bad shape already before the crisis, but in any case deteriorated rapidly and dramatically due to crisis events.

This in turn implied an abrupt change in market sentiment towards many sovereign borrowers, boosting spreads or leading to a complete drying up of market financing for some countries.

High refinancing costs in turn deteriorated fiscal sustainability further, which in turn weighed on market trust.

Deepening recessions resulting from pro-cyclical emergency fiscal consolidations further aggravated fiscal sustainability concerns, which were also reflected in the increasing emphasis of the IMF and of rating agencies on economic growth as a vital component of fiscal sustainability.

The fiscal crisis, deep recessions and, in several countries, real estate price crashes in turn weighed on the viability of banks or whole banking systems. Loss of trust in banks resulted in open or silent bank runs, capital flight, and sharp firm value deterioration of banks.

Banks' bad shape in turn further aggravated the real economic situation, through financing constraints, additional fiscal costs from bank rescue packages and negative expectation effects.

Missing coherence in the economic policy of the member countries and the therefore increasing economic divergence instead of convergence inside the EU further contributed to the problem.

In the EU, the finding of solutions is complicated by two specific factors:

1) A large number of players is involved. The difficulties to find political consensus inside the Euro Area lead to long decision lags, which contribute to uncertainty and loss of confidence.
2) The highly uncertain consequences of various courses of action. No one can seriously tell with any reasonable certainty, e.g., how serious contagion in case of an exit of Greece from EMU on other countries might be. So, as a result, the negotiations and decisions are additionally complicated and hampered by different perceptions and claims about the externalities to be expected from providing or not providing external aid. This in turn generates highly complicated incentive structures and negotiation constellations.

In the light of the inability of the existing political structures to react quickly and decisively, monetary policy was forced to intervene. The ECB was ready to step in and addressed unconventional times with unconventional measures. These measures have on several occasions managed to calm markets and restore some trust and confidence – but not completely and not permanently. It is clear that monetary and liquidity policies can only buy time, bridge temporary dysfunctionality of financial systems but cannot solve deep-rooted structural rigidities in Member countries' economies, solve unsustainable fiscal policies and compensate for political decision-making deficiencies.

2.4. To restore Confidence, Institutional Changes are needed

As economist, in order to determine the appropriate actions we should have a look at the problem in a scientific and not a moralistic way. One has to realize that we have to produce appropriate reactions to a specific problem.

An appropriate reaction to the crisis certainly has to address mis-specified incentives in various fields. On the micro-level principal-agent problems in the form of remuneration schemes have to be tackled, while financial markets have to be further encouraged to elaborate on their risk measurement techniques in order to appropriately evaluate risk. On the governmental level, changes in financial market regulation and economic governance have to prevent the build-up of future potential bubbles and imbalances.

In creditor countries and especially in Germany, political and public support for unavoidable support measures and the related financial costs needs to be firmly built on a clear understanding among political decision-takers, social partners and the public at large that these rescue costs may be small compared to the costs of a halt to the European integration process. The 'cost of non-Europe' would reach far beyond economic costs – after all, let's bear in mind that Europe in the end is a historical political, cultural and peace project. So, clearly, help to partner countries needs to be tied to precise conditions which ensure that the funds provided are used fruitfully for the benefit of lasting economic recovery and prosperity. But equally clearly, given the conditions are met, such help is indispensable.

Economists should further draw conclusions from their expertise of economic history. The developments following the economic crisis of 1929 clearly highlight the potential of economic crises to cause catastrophic political developments. While certain countries like the US could overcome the economic problems by democratic means, countries like Germany and Austria faced a break-down of their democratic systems. This development was caused by mistakes of central banks and partly induced by a single-minded concentration on austerity policy that led to soaring unemployment supporting anti-democratic powers. We all know that this development lead to the biggest catastrophe in European history, the takeover of fascist regimes in Europe and WWII.

Drawing on recent discussions we have had at the Bank for International Settlements, I can assure you that central bank governors around the world are aware of this risk. To prevent such devastating developments is at the top of our agendas. In the current situation, it might be a stroke of luck that one of today's main players of financial architecture, the Chairman of the Board of Governors of the Federal Reserve System, Ben Bernanke, is a well-known expert on the Great Depression with outstanding knowledge about appropriate economic policies.

And in fact in the recent crisis of 2008/2009 central banks world-wide took immediate and massive action, while fiscal policy reacted mainly via automatic stabilizers. All this has been and is not without risks and not without costs, but it prevented the world economic and financial system from breaking down. Today, however, we are in a different situation: now we have to deal with specific regional and structural problems and tackle the task of developing the institutional framework that will enable us to prevent crises in the future.

EU political leaders have recognised the necessity for change and triggered a debate about the fundamental structures of the EU, to be discussed at the EU summit on 28th June. At the meeting further steps towards the creation of a political or fiscal union as well as substantial changes in the EU financial market regulation are on the agenda. In addition, decisions about common banking supervision, common deposit insurance and common resolution schemes could result.

The Eurosystem will stand ready to accompany the adjustment processes, as it has done since the onset of the crisis in 2007. But there is no question that the Eurosystem has stretched its possibilities very far already, piling up substantial risk in central bank balance sheets. Central banks and monetary policy can certainly not substitute for missing political decisions in other policy areas. Thus, addressing the political dimension of the confidence crisis by institutional change will be the key to solving the current economic, fiscal and financial crisis.

2.5. Concluding Remarks

I hope and expect that this SUERF and OeNB event will help us to enhance our understanding of existing constraints but also knowledge about the full range of available policy options.

Ladies and gentlemen, it is a great pleasure to have you here. I very much look forward to the presentations and discussions. Welcome to Vienna, enjoy the programme!

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

András Simor

Good afternoon, ladies and gentlemen. It is a privilege for me to address this distinguished audience at a time which I consider to be a crucial junction on the road to a truly integrated and globally competitive Europe.

I was asked to speak about the interaction of politics, fiscal and financial policies in the context of the crisis. I have to admit that although in the last few years I have gained some insight into the interaction of fiscal and financial stability – more precisely – instability, politics is still a black box to me. It has its own logic, own law of motion, which is sometimes orthogonal to economic wisdom. Bismarck, a wise man, said: "Politics is the art of the possible". In the last few years we had to learn this lesson the hard way.

In my contribution I will talk about the 'frictions' between political will and economic rationale both in European and Hungarian context. In Europe, political feasibility became a binding constraint to many economically rational ideas put forward for containing the debt crisis. Indeed, it was easier to identify the politically palatable crisis resolution methods which can fix the problems in the short run than to come to an agreement on ones which can be a basis also for longer term cooperation and stability in Europe. The slow reconciliation process and uncertainty about the measures governments are ready and able to agree on and implement contributed to the escalation of the crisis in Europe. In the first part of my speech I will deal with the European governance reform, with special emphasis on the areas where we apparently have run into our political limits, and the actual results do not meet the criteria an economist would set to calm the fears fuelling the crisis, let alone to improve the chances of growth and economic competitiveness in Europe. In the second part of the speech I will give a short assessment of the economic developments in Hungary in the light of some economic policy measures taken recently. In my home country, the relationship between politics and economics was the opposite of what characterized the Euro area. Politics was the more innovative player delivering a wide range of unorthodox ideas to fix economic problems. But the economy kept following its own rules, and the outcome did not always meet even the expectations of the politicians, on the contrary, the measures sometimes turned out to be outright counterproductive[1]. I will talk

1 Annual Lecture 2012 and history of Annual Lectures.

about this because the Hungarian story might provide more general lessons about reform fatigue and the difficulties in maintaining the impetus to deliver multi-year fiscal consolidation packages in a low growth environment.

First, I would like to share with you a few thoughts on Europe. Let me start by going back to the inception of the currency union. At that time there were strong economic and geopolitical arguments to intensify economic cooperation among European countries. A common currency, a large currency bloc was thought to be a good instrument to reinforce the competitive position and leading role of the region in the global economy. Moreover, the previous exchange rate regime did not work smoothly. As international capital flows intensified, the fixed exchange rate regime became increasingly prone to frequent speculative attacks. This period was characterized by a global tendency to change intermediate exchange rate regimes to corner solutions.

While a currency union had the potential to deliver substantial economic benefits for the participating countries, the founding fathers of the union had to cope with serious political constraints. There was very little appetite for a federal fiscal structure to support the smooth functioning of the currency union. Political constituencies had different social preferences, showed limited willingness to give up sovereignty, and opposed large scale supranational redistribution. The architects of the eurozone therefore came up with a compromise solution. They engineered a monetary union without fiscal union. It is based on the assumption that all participating countries behave as if it were a credible hard peg, similarly to a complex system of currency boards. As we all know, a credible hard fix is one of the most difficult regimes to maintain, because all macro policies should be fully subordinated to exchange rate policy.

However, the constitution of the eurozone set more limited safeguards to maintain the sustainability of the exchange rate regime. Two clauses, namely the 'no bail out' and the 'no monetary financing' clauses, were established to prevent free riding, assuming that under these constraints self-control is in the best interest of individual governments. The Treaty did not set further requirements regarding stabilization policy in the member states. It was believed that the irrevocable fixed exchange rate would constitute a super credible nominal anchor, and in case of price divergences the real exchange rate would act as an automatic stabilizer in the member states.

In the first decade of its existence the eurozone operated as a safe haven. Financial markets made little distinction between the countries under the euro umbrella. Every country had access to cheap finance in the European money and capital markets. However, the governance structure was not able to ensure the stability of the commonwealth. It turned out that the fiscal rules defined by the Maastricht Treaty were not incentive compatible, circumvented by many governments and on many occasions. The real exchange rate did not act as an automatic stabilizer. On the contrary, real exchange rate misalignments prevailed; amplifier mechanisms took hold, resulting in a significant loss of competitiveness in several member states. Unlimited access to cheap finance created debt overhang in many areas. The international investment community was willing to fund fiscal imbalances, financed local asset price bubbles and credit booms. Large financial imbalances emerged, sowing the seeds of the debt crisis.

The outbreak of the debt crisis revealed further weaknesses in the governance structure of the eurozone. The most remarkable phenomenon we experienced was that – like currencies before – national government bond markets became targets of speculative attacks. We had to learn that the negative feedback loops between funding costs and growth can result in multiple equilibria, and the negative outcome can hardly be avoided without a credible lender of last resort for the troubled governments. But there was no sovereign lender of last resort in the euro area, and the fear of potential insolvency fed the debt crisis in a self-fulfilling way in several peripheral countries of the eurozone.

The second lesson we had to learn was related to the burden of bailing out banks operating in the integrated financial markets. Charles Goodhart said that banks are international in life but national in death[2]. More precisely, the dead banks are national in the sense that the burden of the bail-out falls on the national governments, but they remain international even after their fall in the sense that they might infect the international financial system. Contagion can spread through many channels in a complex way. The fear of complexity and doubts whether the authorities can fully capture all the shock transmitting channels contributed to a delayed balance sheet repair in the European banking sector, and I suspect that it also contributed to postponing the fundamental treatment of the insolvency problem in Greece. However, the prolonged period of uncertainty in the European banking sector's balance sheet was a source of significant economic cost. Anaemic lending activity hindered the recovery of the whole European economy.

Another aspect of the problems facing international banks lies in the limited cost absorbing capacity of the national sovereigns. Government debt swells when the sovereigns have to inject large sums of money into troubled banks. In smaller countries the bill of rescuing large banks can endanger the sustainability of public finances of otherwise fully disciplined governments. It can develop into a vicious circle. The potential cost of bailing out the banks can increase the perceived riskiness of the budget. It has a negative feedback effect on the banks themselves, as they hold large amounts of securities issued by their sovereigns. So the balance sheet risk of the banks gets bigger, which blows up the contingent liabilities of the

2 Goodhart (2009).

fiscal. The third loop comes via the growth channel. Both the weak bank balance sheets and enforced fiscal consolidation weaken the economy, which causes further deterioration in the balance sheets of both banks and the government.

Ireland is an obvious example. In the first phase of the crisis they saved their troubled banks at huge cost, I suspect having also in mind that failing banks could have triggered detrimental chain reactions in the European financial system. The bank bail-out was financed from EFSF, but was channelled through the government balance sheet. Due to the large increase in debt, the government lost all manoeuvring room to cushion the deleveraging process.

I consider the interlinkages between banks and the government as the deadliest shock propagation mechanisms in the European debt crisis: It still has the power to prolong the crisis and to fuel further deterioration in the assessment of fiscal sustainability.

All in all, when the crisis hit the economy, we had to learn the hard way how the missing institutions and limited risk sharing in the European governance system unleashed unexpected shock amplifiers. European policymakers were faced with a really awkward situation. They had to fix the architecture of the commonwealth while it was continuously shaken by a devastating turmoil in financial markets.

We have seen several rounds of institutional changes aimed at fixing the system and calming the markets since the escalation of the Greek problem. However, every time the tranquility of the market turned out to be short-lived, and concerns over the solvency of some banks and sovereigns have revived soon. The European think tanks published their comprehensive 'to do' list in a relatively early phase of the crisis; however, the steps actually taken were far less ambitious and covered a rather limited area of the suggested reforms. Now let me have a look at the recommendations from the point of view of a naïve economist, not internalizing any political constraints.

- in the first place, all advisors mentioned the repair of the fiscal rules. The most important requirement is incentive compatibility, or at least enforceability. It is the easiest one, as fiscal discipline is embedded in the Treaty, but we have to make existing rules more functional;
- in terms of macroeconomic stability, enhanced discipline should not be confined to fiscal policy. Private sector excesses can also derail a country from the sustainable growth path even in a currency union. So we need a mechanism for policing financial imbalances as well;
- the most obvious recommendation was that we need an area wide crisis resolution mechanism. We need a lender of last resort for the governments, but in order to break the detrimental bank-government interlinkages we also need supranational banking resolution funds and a supranational

deposit insurance. However, common resolution funds inevitably involve risk sharing among member states. In theory it should not go far beyond the scope of fiscal burden sharing set out in the Treaty, because it can be set up on an insurance basis, similarly to the deposit insurance schemes prevailing in many countries. However, this is difficult to establish at a time of immediate payouts, when the contributing and the recipient countries are more or less predefined;

- enhanced risk sharing should be accompanied by enhanced supervision at the same level where we distribute the potential costs. So the economists' recommendations call for new European level institutions. Financial sector supervision, both the macro-and the micro-prudential regulation should also upgrade to supranational level. This move can also be justified on the basis of interconnectedness of the financial sectors among the European countries, but the need for a common bank resolution fund makes it indispensable indeed. However it involves political difficulties, as some countries might perceive it as an intrusion into their national sovereignty, over and above what has been agreed at the time of joining the Union.

Let us see where we stand now in the European governance reform. We have seen a lot of efforts, and a lot of changes. But the new architecture is far from finished. I would rather characterize the current state of affairs as a point from where we cannot turn back, but are not ready to move forward enough.

It was relatively easy to move ahead in areas where the responsibilities and obligations of the individual member states had to be tightened. Now we have a six-pack and a fiscal compact. Besides the empowered excessive deficit procedure we have also established the excessive imbalance procedure. Regarding the latter, let me remind you that we have not seen yet how many teeth the new lion has. It can be extremely difficult to persuade countries to implement the structural reforms recommended by the Commission in a range of areas where there are no pre-set benchmarks and actual practice is diverse among the member states.

Not surprisingly, the political constraints proved to be most binding in establishing the crisis funds. Under strong market pressure some sort of crisis resolution mechanism has been established. The EFSF and the ESM can provide liquidity for the troubled governments. However, these newly established funds did not deliver the expected results. They were not able to stop speculation against government bonds in some countries. Their limited efficiency is related to the inadequate magnitude of the funds. The *raison d'être* of these funds is to provide – practically – unlimited bridge finance for their clients. Consequently, these funds are only credible if they are beefed up with ample funds, or at least there are established mechanisms to expand their capacity.

The difficulty to raise large enough funds goes well beyond the traditional refusal of the transfer union or lending with uncertain payoff by political constituencies. This is the case because liabilities of undefined magnitude can undermine the credit rating of the contributor countries as well. Especially when the financing goes for countries where the border line between liquidity problems and solvency is blurred involving a lot of judgment and politics.

Politicians are still searching for the proper ways to lever up the rescue funds without endangering the fiscal position in the donor countries. An idea frequently discussed among economists is the issuance of Eurobonds[3]. The proponents assume that, backed by the taxing power of the whole union, such bonds would be priced more favourably than the average funding cost in Europe. However, this idea does not pass the test of political feasibility. I believe it can only be implemented if the new financial arrangements are discussed as a part of a complex set of rights and responsibilities compatible with enhanced risk sharing among the member states.

During the prolonged political discussions about fund raising, the financial market situation deteriorated to such an extent that the ECB was forced to intervene in order to prevent a further destabilization of the financial markets. Providing lending for troubled governments is strictly forbidden by the Treaty. Consequently, when stabilization of the financial system required fast action, they emerged in the form of unorthodox and not fully targeted measures. First the SMP (securities market program), then the LTRO provided temporary relief for government debt markets in the peripheral countries. However, it should be stressed that the ECB won't solve the governance issues in Europe. It is the task of the politicians. Neither can in my mind a central bank effectively tackle solvency issues, which if treated merely by the addition of liquidity, tend not only to postpone the real solution but also to enlarge the problem itself.

Limited willingness for risk sharing and the financing capacities of the rescue funds had decisive consequences regarding the design of the new institutions, which were set up to deal with risks arising in the banking sector. New European bodies have been established for macro-prudential and micro-prudential resolution, but their role is rather limited. They are coordinative, advisory bodies without powerful instruments. There has been little progress towards a supranational resolution regime in Europe, and recent regulatory proposals aim at defining the burden sharing rules between home and host countries. The current setup is a deadlock situation: without efficient and powerful supranational supervision there is no centralized resolution regime. But as long as the sovereigns have to foot the bill, the member states will not give up their privilege to supervise and

[3] BOFINGER et al. (2012), VALLÉE (2012).

regulate their local banks. I am rather disappointed by the state of things in this field. I want to reiterate that I consider the bank-government interlinkages as a key amplifier mechanism in the current crisis.

How will the European Union evolve in the future? The economic rationale is that it should evolve in the direction of deeper fiscal federalism. To have a successful currency union and efficient integrated financial markets we need a few properly funded institutions to preserve financial stability. It is not about large fiscal transfers among member states, but rather about how to preserve the public good across the Union. I believe that there can be no efficient and globally competitive free market for financial services in Europe without European level supervision and resolution. The dynamics, the direction of the process, is in the hand of politicians. Extraordinary situations require vision and bold initiatives[4].

In the second part of my speech I would like to speak about the interaction between politics and economics in the context of, my own country, Hungary. Our experience might be relevant for a wider European audience as well, because Hungary had to overcome a balance sheet crisis similar in many respects to that experienced in the periphery countries, and we also had to go through a major fiscal consolidation that started as early as 2006.

In the last decade, benefiting from strong global risk appetite, Hungary accumulated a large external debt, financing an inefficient and oversized public sector and, to a lesser extent, the expansion of non-tradable activities. Then a large shift in risk perception and a dramatic rise in the price of external financing forced on us a painful adjustment period. Now we are facing a period of deleveraging, both by the public and household sector. Another similarity to the situation in the periphery countries is that monetary policy has very limited manoeuvring room to support the rebalancing process in the economy. The private sector has a large unhedged FX exposure; consequently the central bank has to pursue its policy goals while also aiming to reduce the volatility of the exchange rate. We have to avoid an excessive depreciation of the currency in order to prevent financial accelerators pushing the economy back into deep recession.

Over the years of permanent adjustment we made numerous efforts to guide the economy back to a sustainable and balanced growth path. The ultimate aim of economic policy was to boost growth and lessen risk premium to prevent debt from snowballing. However, the range of available instruments was limited. Neither fiscal nor monetary policy had manoeuvring room to cushion the fall in domestic demand. On the contrary, the government had to deliver a sizeable reduction in the government deficit in order to strengthen long-term fiscal sus-

4 Van Rompuy (2012).

tainability, while the central bank had to maintain tight monetary conditions to prevent an excessive depreciation of the currency.

So far the results have been rather disappointing. While the underlying fiscal position improved a lot and we now ran large current account surpluses, the economy slipped back into recession following an anaemic rebound in 2010 and 2011, and we still pay as high a risk premium as at the height of the crisis. Consequently, the dynamic component of the debt accumulation almost mitigates the large progress in the flows. Therefore, after six years and dozens of austerity measures we are just implementing another large fiscal consolidation package to meet the deficit targets. While the escalation of the European debt crisis contributed to the recent fall in the economy, it has been driven mainly by some ill-fated economic policy actions of our own government. Let me share with you a few thoughts about our prolonged and unrewarding struggle for growth and how it diverted our economic policy towards unorthodox proposals which prove to be quite difficult to comprehend from an economic point of view.

In a deleveraging country which has to repay its external debt, growth must be export driven. However, we faced strong headwinds from the global economy and especially from the European debt crisis.

Nevertheless, there is no alternative, if the export markets are weak and fragile, the only way to create growth is to gain market share. The governments in power had a narrow margin to influence the competitiveness of the economy. They facilitated an internal devaluation and introduced several structural measures in order to increase the flexibility of the economy and to provide a boost to the economy's growth potential.

In the last six years Hungary delivered multiple structural reforms. Under financial distress, these reforms had a dual objective of enhancing fiscal sustainability and raising potential growth. Among others, many changes took place in the area of local administration, the pension system, education and health care. Large part of the reforms targeted the low participation rate in Hungary, which constituted a fiscal burden and led to a significant loss of productive capacity. The measures involved abolishing several types of transfers, tightening eligibility criteria and modifications to the compensation schemes to make work pay. As a result, the system increases incentives to work, which is reflected in the rise of the participation rate. Although the full impact of the measures will only appear gradually over a decade, the share of people active in the labour market has already increased by 2 percentage points since the beginning of the crisis.

Even if the structural measures form a coherent strategy, which was not the case in our country, in the current global juncture it takes an extremely long time to see the benefits of the reforms. Structural measures increase the productive capacities of the economy. However, supply shifts have little direct impact on actual growth if the economy is operating below the full capacity utilization level, and it is unable to absorb the expanding production factors. Another cause for the little reward for the reforms is the elevated cost of capital. In normal times, when the crisis and fiscal adjustment are confined to a single country, a brave austerity package may reduce the risk premium via non-Keynesian expectation channels. In a global crisis however, there is little positive feedback. As long as both domestic and external financial markets remain vulnerable, the uncertain demand outlook and the deterioration in funding conditions impede investment. Even if there is some scope for reallocation between labour and capital in the production process, without investment labour demand remains subdued. We can observe these trends in Hungary. In addition, our situation was aggravated by the fact that while some of the government measures boosted labour supply, others actually cut the demand for labour by sharply increasing the minimum wage.

Even if initial political support for the reforms is wide, it can vanish quickly, as the period of weak economic performance gets extended. In normal times, politicians sell the fiscal consolidation measures saying that although many voters get a smaller piece of the pie now, the reforms will help the pie grow bigger, and everybody will be better off. The problem is that in crisis times the pie keeps shrinking. And we have to implement one measure after another to meet the fiscal targets, while we also keep learning about the nature and deepness of the problems of the country preventing a better performance.

When the economy becomes stuck in stagnation and reform fatigue grows, disappointed politicians might turn to uncharted waters to obtain a quick remedy for the ailing economy. The unfortunate by-product of the reform fatigue we have observed in Hungary is that some measures, initially targeting clearly identified economic problems, might be misused or might get a sort of 'ideological' distortion. In other words, in order to maintain the appeal for the constituency, the primary burden of the adjustment is shifted to 'non-voting' economic agents, sometimes accompanied with rather offensive rhetoric. These twists in the measures might have detrimental consequences, because they impair the investment climate in the country. In our case investment activity fell to historic lows and potential growth decelerated despite all the efforts and structural reforms. Besides the uncertain outlook and the unpredictable environment, limited access to external finance and fast deleveraging in the banking sector have also contributed to the dramatic drop in investment in Hungary. Let me give you two examples to illustrate how the original intention and the rationale behind some economic policy actions might get diverted and become counterproductive.

My first example is related to the so-called fiscal devaluation, which is an often recommended tool to boost competitiveness in a country lacking exchange rate flexibility. In Hungary a large adjustment in unit labour costs took place in the last few years, which will hopefully enhance our market share once growth resumes in our main export markets. The flexibility of the Hungarian labour market facilitated a significant reduction in real wages. In addition, competitiveness was also supported by the large-scale restructuring of the tax system from labour income taxes towards consumption taxes. It was an important step, as the highly progressive labour income tax and widespread tax avoidance were identified as serious impediments to growth. However, as the initial steps did not deliver fast and visible results, the government, badly wanting to accelerate growth, started to overstretch the limits of the tool. While in the first round the reduction in labour taxes was financed from excise and value added taxes, later on new sectoral business taxes were introduced to compensate for the decline in revenues from labour taxes. The government assumed that – giving a boost to external competitiveness and consumption – the economy would recover soon and the new taxes could be abolished in three years' time. Not surprisingly, growth did not resume, and now the so called 'crisis taxes' are just about to get transformed into more permanent ones. While bad luck, I mean the headwinds from the Eurozone also contributed to the disappointing growth outcome, the regulatory uncertainty arising from the unorthodox, distortive Robin Hood taxes played a significant role in the deterioration in sentiment towards investment in Hungary.

Another example of how the intentions of a financially distressed government might get derailed is the case of household FX debt in Hungary. Hungarian households accumulated a large unhedged foreign currency debt before the crisis. This process was partly demand driven, but also encouraged by the banks, which were mostly subsidiaries of foreign parent companies. When the crisis hit the economy, the currency depreciated, and the debt burden was further increased by the higher interest rates, since the banks repriced their loans to compensate rising funding costs and to cover all the losses caused by deteriorating portfolio quality. The delinquency ratio started to rise fast, generating a serious social problem. On the other hand, it became the most important economic problem as well. It withheld consumption, dampened credit via deteriorating bank balance sheets, and made the whole economy extremely vulnerable to exchange rate volatility. From an economic point of view, a government intervention to tackle the problem was fully justified. Based on other countries' experience, such an intervention can be useful to clean bank balance sheets and to restart lending activity. However, in Hungary there were two features of the program which diverted it from its original purpose. First, the financially constrained government tried to shift most of the burden onto the banks and their foreign owners. Second, the implemented measures targeted the middle class and not the hopeless nonperforming portfolio. Consequently, the costs the banks had to swallow were mostly related to the performing portfolio, and there was no improvement in the portfolio quality while large capital losses occurred. As a result, these measures did not facilitate lending. On the contrary, they can be considered as counterproductive from a growth point of view.

Despite many good intentions and many progressive structural measures, Hungary fell back into recession this year. It is difficult to disentangle the role of external and internal factors in this poor performance. But it is not unjustified to assume that unorthodox measures which missed rigorous economic cost-benefit analysis have been the main contributor to the disappointing economic performance.

Why do I tell you this story about Hungary? It is a warning that might be relevant for a wider audience. The struggle for growth gets more and more desperate in many countries around the world. While the tolerance of the society is waning, monetary and fiscal authorities are running out of conventional weapons. Monetary policy is constrained by the zero lower bound and large scale liquidity injections have diminishing returns as we face credit and insolvency problems. Fiscal policy is constrained by unsustainable budget deficits and public debt in most advanced economies, thus limiting options for further fiscal stimulus. And the culprit in Europe is that the financially distressed sovereigns can hardly absorb additional losses from the banking system and the inability to ring-fence the troubled banks proliferates the systemic risks all over Europe. At such a juncture there is a high demand – as we say in Hungary – to pull out new rabbits from the hat, to find unorthodox measures to facilitate a less painful adjustment of the economy. I hope our profession will have the possibility to provide good advice and useful warnings and we can provide a compass for politicians in these uncharted waters.

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4. The Political Economy of Sovereign Debt Crises

Iain Begg

4.1. What needs Explanation

The sovereign debt crisis has now dragged on for nearly three years since it first surfaced after the Greek election in 2009. It has exposed differences between Member States not only in what they see as the roots of the problem, but also in how they would like to see EU economic governance evolve. Some would prefer a rules-based, stability-orientated system, while others are determined to retain political discretion; some blame the profligacy of the debtor countries, while others blame the cavalier approach to lending of the creditors; and there are those who say the problems were always there in a flawed system, while others blame poor policy choices and failures of implementation in an otherwise sound frame-work.

Markets cannot be exempted from criticism. For much of the first decade of the euro, spreads between sovereign debts of euro area members had been converging to only a little above the rate on German bunds, only to diverge rapidly from late 2008 onwards. The clear implication is that markets either failed to detect the growing risks from increasing current account imbalances and the growing asset bubbles, or were prepared to believe that the euro's no bailout rule had no credibility. That they suddenly switched in 2008/9 manifestly contributed to the gathering crisis.

The crisis has also exposed the inability of the euro area members to react quickly, so much so that the wonderful instrument of hindsight suggests that had action been taken sooner and in a more decisive manner, the problem would have already been solved at much lower cost. However, it can equally be argued that a response has been hampered by a lack of experience in handling so acute a crisis and the political economy of dealing with it has to take account of the natural tendency of politicians (and, indeed, other actors) to minimise the threats. In addition, a crisis of this magnitude was not anticipated by the authors of the Treaty and of the other instruments and institutional arrangements that make up the economic governance frameworks. In short, there was no readily available toolkit.

4.2. A Political Narrative

It is in the nature of crises that they come as a surprise, not least because when everything looks rosy it is hard to believe that demons are lurking. Hindsight is again revealing, if not much use. Everyone now knows that the surge in property investment in Spain or in house prices in Ireland had gone much too far. Similarly, the rise in unit labour costs of all the 'club med' countries relative to Germany – which was of the order of 30% between 2000 and 2009 – was bound to have repercussions, and the yawning current account deficits of Spain and Portugal (10% of GDP by 2008) and even more egregiously of Greece (15% of GDP in the same year) should have been seen as severe warnings of the trouble ahead. Meanwhile, the large surpluses of Germany, the Netherlands and Sweden ought to have been recognised as potential sources of instability, however laudable they appear from inside these countries.

It is also in the nature of economic crises, as opposed to security or health scares, that their extent and ramifications are slow to be recognised. As a result, there is an inevitable reluctance by those in power to take responsibility for finding, paying for and implementing solutions. The unfolding of this process – visible during the euro area sovereign debt crisis – can be characterised as a four-stage sequence of responses:

- The first is denial. Particularly for those in charge, the temptation will always be to play down the problem and to portray it is a 'bump-in-the road', rather than a much more fundamental difficulty.
- In a typical second stage, the need for action is recognised, but the measures adopted are taken only reluctantly and calculated as the minimum necessary to deal with the problems. In parallel, scapegoats are sought and blame levelled at one or more of: the previous government; speculators or rapacious bankers; global phenomena outside the control of the authorities (for example, commodity prices); or partner countries that have been happy to take advantage of market opportunities. This process of blame-shifting leads to procrastination and a reluctance to accept responsibility. It is the sort of game where each can see the potential losses, but none the potential pay-off from rapid action.
- As the gravity of the position becomes increasingly clear, there is a search for the magic bullet that will slay the demon, often leading to misplaced hopes that the latest deal will produce it. Unwarranted faith is pinned on the latest wheeze. Then, as successive meetings and initiatives fail to resolve the problems, uncertainty is accentuated and what might have been a containable crisis becomes more threatening.
- At this point, optimism collapses and the sense grows that there is no way out. Mounting internal and external political pressures lead to ill-judged decisions and even panic.

The crisis has also prompted a difficult debate around who should do what and what the limits of mandates are. This has been especially true of the ECB which has found itself obliged to act as the *de facto* lender of last resort and to adopt emergency measures that would have been unthinkable as recently as two years ago. This stretching of mandates occurs because the costs of the alternative (intensified systemic problems, threats to the euro) are considered to be so great or so unpredictable (Pandora's box) as to be unthinkable. Yet the outcome can be to push different actors into profoundly uncomfortable territory. Thus, some of the ECB's actions have seen it undertake quasi-fiscal actions by facilitating borrowing by governments. While the strict legality of these actions is open to dispute, they certainly stretch the definition of the treaty restrictions on bail-outs and monetising public debt. Similarly, the constitutional arrangements in Germany are close to breaking-point, even without the evident pressures from public opinion.

Citizens are also part of the political narrative, even if prone to be neglected or taken for granted. Among the creditor countries, populist sentiment facilitated the advent of the true Finns and the consequent demands for Greek collateral, while the collapse of the Dutch and Slovak coalitions – the latter reflecting the far from unreasonable question of why poor Slovaks should be rescuing much more prosperous partner countries – have the potential to cause a hard-fought agreement to unravel. The growth of populist parties objecting to cross-border rescues also testifies to a diminishing solidarity. Resentment of onerous conditions imposed on their counterparts in debtor countries has raised incentives to resist onerous conditions for loans, especially where the domestic political discourse blames bankers or politicians.

4.3. A Plethora of Political Economy Concepts

A range of political economy approaches help to explain the challenges facing governments. There are, first, overlapping games. These take place within a Member State and embrace government and opposition, reconciliation of factions within parties or coalitions and the need to consider media stances. Assuming a single national position can eventually be cobbled together, parallel games take place between Member States, and will often go beyond the immediate issue – be it agreeing a bail-out, reforming institutions or changing rules. Member States will bargain with the aim of advancing longstanding preferences and will often combine short and long-term demands.

A further game has been taking place between different institutions. Governments acting collectively in the Council of Ministers have been slower to act than the ECB, but the ECB has latterly made clear its discomfort with many of the actions it has been obliged to take, through carefully leaked reservations attributed to worried members of the Governing Council and the warnings to government issued by its President. At its worst, this sort of game becomes buck-passing that inhibits concerted responses.

Underlying many of the disputes is the straightforward, if often intractable, issue of how burdens are shared in orchestrating solutions. Creditors, unsurprisingly, expect debtors to exhaust their own capacity to pay before being willing to risk (or bear) losses, but the true incidence of risk can be obscured. As expressed in an old joke, if you owe the bank a huge sum and cannot pay, it is the bank that is in jeopardy, not you. Seen through this lens, the true incidence of a default by Greece may be on French or German banks, or central banks within the Eurosystem that have large outstanding Target 2 balances

This simple proposition leads to the question of where the balance of power lies between creditors and debtors: can recent events best be described as a dictatorship of the creditors or blackmail by the debtors? Moreover, an explicitly political dimension, which touches on the legitimacy of the actions taken is whether particular groups such as bankers or incumbent politicians should be held directly accountable. A further political economy consideration can be summed-up in the rhetorical question "who is holding whom to ransom?".

Debtor countries know that if they default, especially in a disorderly manner, it becomes a problem for creditor countries. Banks considered to be systemic have had a de facto state guarantee which has allowed them to take greater risks than they might otherwise have done because part of the risk is borne by taxpayers. In both cases, the risks are greater where the web of connections among financial intermediaries is extensive: both 'too big' and 'too connected' to fail are watchwords where this is the case. Ordinary tax payers are asked to pay for rescues while the affluent rich often have the wherewithal to avoid or evade taxes. A ransom game is also played out at an institutional level. At various points the ECB has stepped in to provide funding required because a lack of action by Member State governments or other institutions had led to perilous conditions. Yet as more is expected of the ECB it faces the Catch-22 that other institutions or actors want to prevent it from accruing new powers.

Contagion is currently the worry for many at European level and here too multiple games are in play. Markets will be quick to pounce on any new signs of vulnerability or reluctance to act, suggesting that decision-makers have to act with great care in anything they propose.

4.4. Markets and States

At times during the crisis, markets and states have seemed to exist in a state of mutual incomprehension. Markets (and leaders of governments in other continents) cannot fathom why Europe's leaders seem unable to make progress on any of the potentially viable solutions that have been canvassed. Politicians, in turn, are repeatedly taken aback when market movements fail to reward tough decisions and substantive changes – of which there have undoubtedly been many over the course of the crisis. How can this be explained?

One factor can be expressed as the notion of political time. Governments can, on occasion, act quickly as they did with some of the 'emergency' weekend deals at the height of the financial crisis in the autumn of 2008, following the demise of Lehman, and in May 2010 when confronted with the prospect of a Greek default. But some of what governments have done over the past has appeared to be very slow, involving consultation, legislative action and deal-making, all in contrast to the immediacy with which markets function.

As a result, markets perceive governments to be ditherers, happier to 'kick the can down the road' – in one often-used metaphor – than to dispose of it. Yet the paradox is that the pace of governance reform in Europe has been faster and its ramifications more far-reaching than in any comparable period. On one side, an obvious explanation is that the incentives for markets are not necessarily stability; on the contrary, in febrile conditions, the opportunities for substantial speculative gains are increased and governments can, at times, be blind to this fact.

Equally, governments have to follow what might be called due process. The extensive reforms taking place have to be explained to various stakeholders and that process of advocacy takes time. Citizens have to be convinced, on the one hand, of the seriousness of the problem, especially (as is the case for those in creditor countries who cavil at being asked to stump up cash for what they see as mismanagement in debtor countries or even fecklessness) when the problem may not have a direct impact on them. On the other hand, what constitutes the 'common good' has to be fully worked out then explained. In parallel, citizens in debtor countries, accustomed to good times, have to be persuaded that unpopular, and possibly even unfair, reforms are justified.

4.5. The unfolding Crisis of the Euro Area

For some commentators, particularly those in what might be called anglo-saxon academic and media circles, the travails of the euro area were predictable. On these analyses, they stem, essentially, from the fact that the euro area was never an optimal currency area and has shown little sign of becoming one since the launch of the euro. The benign conditions of the euro's first decade may have masked the profound flaws in the architecture of monetary union, but in today's more difficult conditions they are being fully exposed. In short, the message is "we told you so, but you refused to listen…".

Certainly, the pathologies of the sovereign debt crisis show that major policy errors were made. The loss of competitiveness of the 'Club Med' countries has been aggravated because – contrary to the optimistic expectations of supporters of monetary integration – pressures to reform the supply-side of the economy have been limited; indeed the pro-cyclicality of monetary policy has fuelled divergence. The policy prescriptions that flow from this 'anglo-saxon' analysis are for the countries now in difficulty to devalue by exiting the euro.

However, while this logic might make sense and can claim empirical support from the experience of many decades of IMF restructuring programmes, it overlooks the fact that there is a huge qualitative difference between a fixed exchange rate system and a single currency. The euro is not a Bretton Woods system, an exchange rate mechanism of the sort that held sway prior to the introduction of the euro, or a reference point for countries that adopt a currency board. Instead, it was established as an irrevocable commitment in which there is no provision for exit. Clearly, this has not stopped rumours about Greece (especially) exiting or being expelled and whereas it is virtually unimaginable that California would exit the dollar to solve its fiscal problems, there is a credible probability of Greece taking this direction.

But the political position of many Member States continues to be that they want the euro to succeed and they will do what is necessary to achieve this end. It is going to be a bumpy ride and markets appear still to believe that the governments cannot prevail. Certainly, the vacillations and reluctance to arrive at comprehensive agreements has added to the uncertainty and disorderly outcomes cannot be excluded. The inference to draw is that there has yet to be a sufficiently convincing political commitment, although markets appear not to have recognised or to have given much weight to the substantial governance reforms that have taken place. Nor do they seem willing to accept the strong statements of leaders.

4.6. The Outlook: Storm Clouds or Sunny Uplands?

Students on an Economics 101 course are routinely told early on that they should never predict exchange rates, because they will invariably be wrong, and much the same advice probably ought to be applied to conjecture about the trajectory of economic crises. It is nevertheless worth trying to identify sources of potential disruption. At the time of writing, many of the risks are immediate though not necessarily quantifiable because of uncertainties; they include:

- the continuing fragility of parts of the euro area banking system, notably because of its exposure to over-valued property and to holdings of sovereign debt. While the June 2012 agreement to allow vulnerable Spanish banks to be directly funded by the EFSF should help, the dangerous linkages between sovereign and bank debt persist;
- bond market reluctance to purchase bonds of vulnerable Member States, pushing up their yields while pushing down those of the remaining 'safe havens'. This flight to safety is reaching uncomfortable proportions and could result in enduring distortions of credit markets and intolerably high costs of financing for the vulnerable;
- implementation challenges which could mean that deals unravel and are then harder than before to create;
- miscalculations of the true scale of risks, causing markets to overshoot, ratings agencies to exaggerate downgrades and the triggering of self-fulfilling prophecies;
- court decisions (notably from the German constitutional court) or political votes (consider how close the Syriza party came to having the largest vote in the second Greek election in June 2012) that derail delicate compromises;
- quite simply, political accidents resulting from miscalculations, ill-judged pronouncements or the failure to understand and heed messages.

Reasons for optimism are harder to find in the short-term, but nevertheless exist, though the medium term promises more:
- perhaps the most significant is that Europe's leaders now 'get it' and realise that they need to develop more comprehensive and effective responses than hitherto. This takes time and time continues to be in short supply, but progress is being made;
- in particular, the many shifts in German positions testify to a softening of its original hard line, although the highly contested issue of mutualisation of debt is still some way from being resolved;
- the components of a new governance framework are gradually being put in place and should improve matters, albeit only when 'normal' times return;
- structural reforms in the southern Member States are gradually being intensified, but it is the nature of such reforms that they can take time to bear fruit;
- even so, substantial adjustments in competitiveness are feeding through and will eventually help to attenuate imbalances;
- at some point, distressed euro area assets are going to look cheap and the corporate sector is now sitting on large surpluses.

4.7. Concluding Remarks

Despite the chorus of criticisms, much has been done by Europe's leaders to deal with the crisis and it has been done in difficult circumstances. The ECB, in particular, has taken actions that have bought time and the onus is now on the politicians to use that time to good effect.

EMU was expected to lead to a gradual convergence in cycles and structures, but the evidence is that the opposite is now happening. This economic divergence is and will remain an awkward problem from two perspectives. First, it will make the task of curbing the imbalances that lie behind the crisis that much harder, and if – as seems to be happening – the divergence accentuates virtuous and vicious cycles, the challenge will be all the greater. Second, it greatly complicates one-size-fits-all policies such as monetary policy, because different economies will require much more tailored policy mixes. An aggravating factor is that country risk has widened the interest rate spread between troubled and stable economies, deterring investment in the South and stimulating it in Germany and other northern Member States. This is not a recipe for convergence or common policies.

As the forgoing discussion has stressed, the EU has embarked on an unprecedented deepening of governance and has already put in place extensive reforms that will assure a much more comprehensive approach to prevention of future problems. The approach is, broadly, a rule-based one and although there are innovations such as reverse majority voting and more graduated sanctions, the litmus test of its effectiveness will be compliance.

There is more to come. Banking union in some form is looking probable and may pave the way for mutualisation of debt, perhaps starting with deposit insurance, although the opposition of several creditor countries to Eurobonds remains robust and will be hard to overcome. The term 'political union' continues to be bandied around, but is an elastic concept that means different things in different contexts. Even so, moves towards it must be expected. The ECB/Eurosystem will inevitably be a key actor and can expect to be assigned additional tasks, but has made clear its concern about staying within its mandate, amid fears that it has already become over-stretched.

Other potential difficulties must be anticipated, especially around the various forms of 'holding-to-ransom' alluded to above. In practice, it is a lack of clarity or certainty on burden-sharing that is at issue and the likelihood is that outcomes will be messy compromises rather than optimal. A differentiation between the seventeen Member States of the euro area and the ten in the rest of the EU in governance arrangements will also need to be confronted, and the numbers game is made more complex when innovations such as the Fiscal Compact involve yet another configuration of twenty-five Member States. It would, moreover, not be a surprise if some euro area members took antagonism – fuelled by domestic objections – to contributing to bailout funds to the logical conclusion of opting-out of common funds. The three musketeers' rallying call may be hard to maintain.

Although there are more grounds for optimism about the prospects for the euro than are routinely presented in the media, it is also evident that the crisis is far from over. The emerging new framework has its critics and may still be incomplete, but should be a substantial improvement However, a roadmap is needed to complete the exit from the crisis and to bridge the gap to this brave new world. Following it will need effective and decisive leadership and a much greater willingness by the principal political actors to take unpopular but necessary decisions. The challenge to them is clear: can they and will they rise to it?

5. The Eurozone Sovereign Debt Crisis – Status Quo, Challenges and Prerequisites for a Solution from an Asset Manager's Perspective

Andrew Bosomworth

5.1. Introduction

For a prolonged period, the Eurozone's capital markets have been prone to high volatility. A lack of clear political decisions have driven government yields of different Eurozone members to extreme levels, leading to refinancing problems for those with high rates.

In essence, the markets have been signaling that the status quo, in place since the introduction of the Euro, is no longer tenable. Most participants from politics and capital markets would agree with this statement; however, it seems that few can agree on what needs to change and how a new stable equilibrium can be found. This is a problem that requires European leaders to provide more clear and decisive signaling.

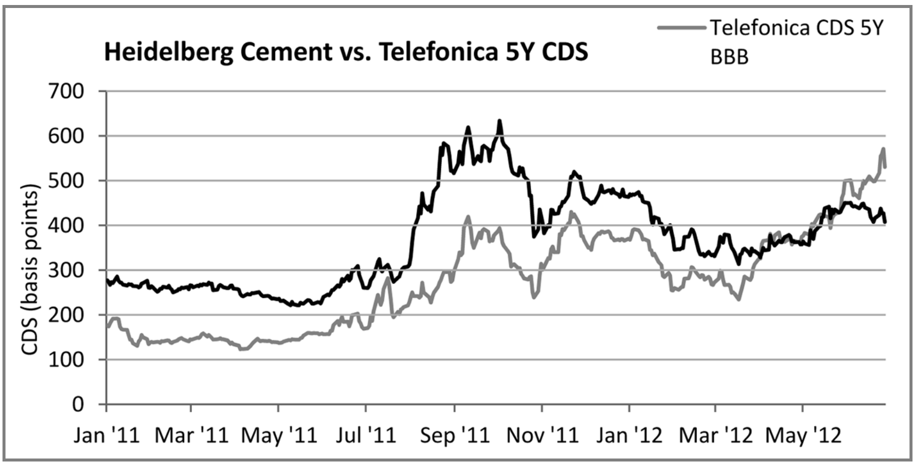
To avoid any doubt: Few investors will enter into long-term capital-allocation decisions without a reasonable degree of certainty about the future parameters of the debtor with whom they are contracting. The more uncertainty investors face, the more they require higher interest rates to discount potentially volatile future cash flows. Accordingly, uncertainty about the Eurozone's future is depriving some of its member states of private capital at reasonable interest rates, as they seek to adjust internal and external balances. The liquidity shortage, if it persists too long, risks tipping into a solvency problem as onerous rates make the debt of some countries unsustainable.

A large asset manager, entrusted by pensioners, savers, corporates and even governments and central banks to invest their savings, has two objectives: first, the return of capital invested, and second, a return on capital. Historically, return on capital has been the main focus of investors and asset managers. More recently, however, this historic pattern has changed to a focus on return of capital. Where does this notion come from and what is the underlying problem?

5.2. Unstable Equilibrium in Europe – How might the Eurozone look in the Future?

Evidence for an unstable equilibrium can be found by looking at distortions in the capital markets. A simple example is shown by the chart of credit default swap rates on the Spanish investment-grade telecom company Telefonica (Ratings: Moody's Baa1, S&P BBB, Fitch BBB+)[1] and the German high yield cement producer Heidelberg Cement (Ratings: Moody's Ba2, S&P BB, Fitch BB+)[2]. As of 30 June 2012, the market commanded a higher credit-risk premium for a BBB-rated firm in Spain than a BB-rated firm in Germany. The different rates between the two corporations results from each firm's underlying reference-yield curves and the market having moved away from pricing sectors across the Eurozone to pricing in a fragmented way based on geography. Heidelberg Cement is based in Germany, where the underlying yield curve is the German government bond yield curve, which has a 5-year yield of 0.6%[3]. Telefonica, a Spanish company, provides a good part of their services in Spain. Therefore, this firm is linked to the overall economic situation of Spain, whose yield curve is priced off Spanish government bonds, which have a 5-year yield of 5.6%[4]. Due to this basis stemming from the different domiciles, Telefonica had a premium of 123 basis points on 30 June 2012 compared with Heidelberg Cement.

Figure 1: 5 Year CDS Premium (bps) of Heidelberg Cement and Telefonica[a]



a. Bloomberg as of 06/30/2012.

1 Bloomberg as of 06/11/2012.
2 Bloomberg as of 06/11/2012.
3 Bloomberg as of 06/30/2012.
4 Bloomberg as of 06/30/2012.

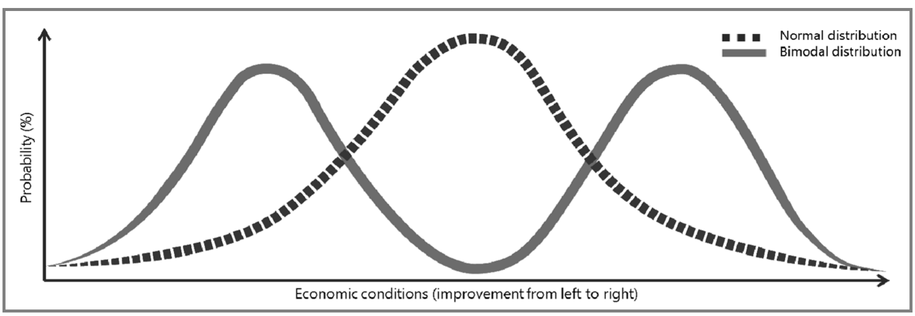
Figure 1 shows the current situation in the Eurozone and clearly points to the conclusion that the status quo is no longer an option. The history of monetary unions is insightful: No monetary union has survived without either having evolved into a proper political and economic union[5], a fact which, at least from a historical perspective, argues for more, not less, integration of the Eurozone, or a break up.

This brings us to the important question: Which direction is the Eurozone moving? With regard to the solution space, there are two corner solutions. One involves a full break-up of the Eurozone and the reintroduction of 17 individual currencies; the other, a full political and fiscal union with all 17 countries maintaining the euro. Of course, there is also an intermediate solution with a smaller group of more homogeneous countries maintaining the euro and decentralized fiscal policy – what we call 'refounding the Eurozone'. But for this to work, if these countries are to maintain a centralized monetary policy with a decentralized fiscal policy, they will have to be very similar in terms of initial conditions, flows and culture.

We usually assume a kind of normal distribution to describe such a scenario, even if it is not a normal distribution in a statistical sense. However, the distribution will have one dominating base scenario with a high probability allocated to it. And this kind of distribution is also what the economic system is geared to. It is the basis for portfolio constructions of asset managers and investors, of risk management systems, and the like.

If the status quo is no longer an option for the Eurozone, then the assumption of a normal distribution of outcomes is also flawed and has to be replaced with another assumption. We believe that this distribution looks more like a bimodal distribution with a not-insignificant probability of a negative or positive outcome for the Eurozone, with the status quo being the lowest probability, in the center.

Figure 2: Bimodal Distribution of Eurozone's Outcome



5 Krämer (1970).

The change from a normal distribution to a bimodal distribution is also reflected in the behavior of capital market instruments. An example would be the way German government bonds behaved in the past and how they would behave with a bimodal distribution. In the past, by investing in these instruments, a positive return with a dominant probability consistent with a normal distribution could be assumed. Today, however, the payoff structure looks bimodal: In case of a negative outcome for the Eurozone, there would be a 'flight to quality' with investors willing to pay a huge premium for the safety of German government bonds, which in the case of a breakup of the Eurozone might be redeemed in some kind of new Deutsche mark; or, if not, yields would decline further owing to the deflationary impact of currency appreciation versus southern Europe. Investors holding these bonds would see large gains on their investments. In the case of a positive solution for the Eurozone crisis, however, investors would sell German government bonds, yields would rise and investors holding these bonds would incur mark-to-market losses. This is also the trend we've seen in the markets for some time now, with 'risk-on' and 'risk-off' moves as investors reposition themselves in one of the two bimodal distributions depending on the current situation in the Eurozone.

What makes it extremely difficult to predict which of the two distributions the Eurozone crisis moves to is a so-called 'butterfly moment' – a term which originally stems from meteorology and describes the fact that a very small incident, like the move of a wing of a butterfly, can have a large impact on the outcome. The Eurozone seems to be in a situation in which small events can lead to unexpected outcomes. These 'butterfly moments' for the Eurozone could arise from election outcomes, court decisions, or unexpected deposit flight. In these events, capital markets can work as accelerators to push the Eurozone into a positive or very negative scenario depending on market expectations.

Summarizing the current situation: there is a tremendous risk of failure with all the negative consequences (the left distribution) and a big opportunity to turn it into a positive outcome (the right distribution). However, the status quo is no longer an option, a view endorsed by the capital markets today.

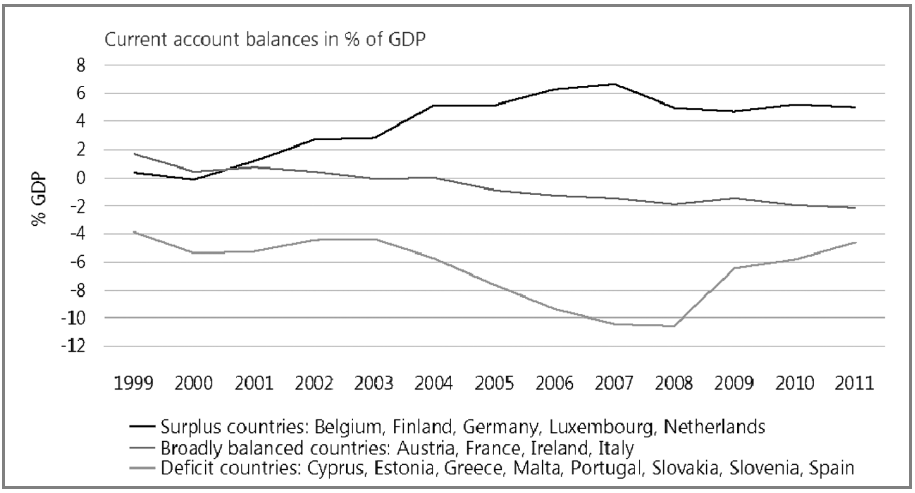
5.3. What Future does Europe want and need?

If Europe is in an unstable equilibrium and if the status quo is no longer an option, what would a feasible solution look like? Listening to politicians from all parties and all parts of Europe, there seems to be a common view that more Europe is needed not less. As Angela Merkel stated recently, "(W)e don't just need a monetary union, we also need a fiscal union, meaning more common budgetary policies, and, in particular, a political union, i.e., we will need to transfer competencies to Europe, step-by-step, going forward, and giving Brussels intervention rights”[6].

There likely is no alternative unless one would be willing to risk massive capital market disruptions with all the negative consequences associated with it. However, the belief of the capital markets in this solution is limited today and several steps necessary to ensure that there will be a positive outcome of the bimodal distribution for the Eurozone.

At the heart of Eurozone’s problems is the divergence among the EMU17 Member States. These differences need to be reduced to enable a stable long-term solution. A prominent example, and likely the most crucial divergence, is the current account positions of the different countries. One set of countries is running large and persistent current account surpluses (Belgium, Finland, Germany, Luxembourg and the Netherlands). Another group has broadly balanced current accounts but the trend is declining (Austria, France, Ireland and Italy). And the third group is running large and persistent current account deficits (Cyprus, Estonia, Greece, Malta, Portugal, Slovakia, Slovenia and Spain).

Figure 3: Current Account Balances in % of GDP[a]



a. As of 31 March 2012 from Eurostat (2012).

The perception of the capital markets, which are commanding a risk premium on the countries’ government debt, is broadly in line with the chart above. However, as we learned in recent months, some deficit countries can no longer refinance themselves on the capital markets, while Greece had to go into debt restructuring.

6 Merkel (2012).

However, the countries are not only different in basic economic numbers but also in less well-known, more qualitatively oriented aspects such as the ease of doing business in a country. It can be seen from the chart below that there is a visible connection between a country being in surplus and having an effective government, a stable legal situation, a small shadow economy and being business friendly, versus belonging to the deficit group of countries which are in a lot worse position with regard to all these parameters. Also, these more qualitative differences have to be aligned.

Figure 4: Basic foundations of doing business in the Eurozone countries[a]

	Control of corruption index	Rule of law index	Government effectiveness index	Size of shadow economy index (%)	Ease of doing business index[1]
Surplus countries[2]	1.9	1.7	1.7	14.2	22.5
Balanced countries[3]	1.7	1.7	1.6	9.6	34.3
Greece	0.1	0.6	0.6	25.0	109.0
Ireland	1.7	1.7	1.3	13.1	9.0
Italy	0.1	0.4	0.5	22.0	80.0
Portugal	1.1	1.0	1.2	19.5	31.0
Spain	1.0	1.1	0.9	19.5	49.0

a. As of 30 September 2011, source: The World Bank; Friedrich Schneider; The Shadow Economy in Europe, 2010; Johannes Kepler University; PIMCO.
The footnote 1 refers to: 1 = easiest, 183 = most difficult; footnote 2: Average of surplus countries.
Footnote 3: Average of balanced countries ex Italy and Ireland.

To ensure the stability of the Eurozone, the differences between the countries in the Eurozone have to be addressed and resolved. Additionally, market participants have to believe that the measures solve the problems, which speaks to the need for trustworthy signaling by Europe's political actors. There has to be a clear description of the destination of the Eurozone. It will take a long time until this destination is reached, which makes it necessary to come up with a credible roadmap clearly describing the way and the actions necessary to reach the destination. There is one historical example in the European Union where such a roadmap was used – The Delors Report[7]. In this report from 1989, a trustworthy roadmap for the introduction of the euro was drawn in which the capital markets could, and did, believe. This 'New Delors Report' would have to clearly describe the destination of the Eurozone and would have to deliver a commitment on the steps

7 Delors Report (1989).

and milestones needed to reach the destination. Four aspects have to be clearly and precisely addressed in this report:

5.3.1. Structural Reforms

There have to be common minimum standards agreed in the Eurozone for the efficiency of the government and labor markets, legal enforcement, taxation and legalization of the hidden economy. These standards also have to be strictly enforced to ensure that they are adhered to by all countries.

5.3.2. Banking Union

The supervisory function of banks in the Eurozone has to be centralized into one agency to ensure that there are minimum regulatory standards for all banks which also are enforced by a central agency and not by different governments with limited incentives to do so. Additionally, deposit guarantees have to be established and unified throughout the Eurozone. This will give a strong signal that inhibits bank runs on weaker banks in peripheral countries.

5.3.3. Political Union

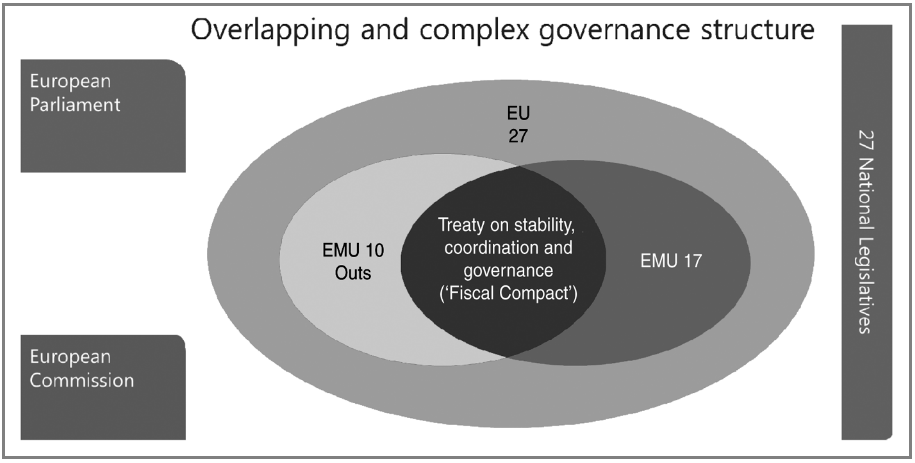
Today, Europe's political-governance structure lacks democratic legitimacy and falls somewhere in between the European Parliament, the European Commission and 27 national legislatures.[8] This is likely the most difficult challenge to enable more democracy on the one hand, and to simplify the complex governance structure, which is shown below, on the other. In the end, democracy has to be balanced with conditionality and mutualization, which will require a clear democratic decision by the national legislatures to hand over more responsibilities to Europe. However, this is a democratic process which necessitates peoples' participation.

5.3.4. Fiscal Union

A euro solidarity surcharge necessary to enable this which will have to be borne by the surplus members of the Eurozone. Every year, for example, the European Union transfers about 1% of its GDP across borders, including about €50 billion to subsidize agriculture and a similar amount to support development projects in low-income regions. A successful example of a solidarity charge is the former German Democratic Republic after reunification with West Germany. In what is now called Germany's eastern states, more than 20 years of subsidies and a successful integration with the western part led to GDP per capita which is higher

8 Pisani-Ferry *et al.* (2012).

Figure 5: Structure for the European Governance Structure[a]



a. Chart adapted from: Pisani-Ferry *et al.* (2012), p. 1.

today than five other countries' in the Eurozone and on par with Spain. As with agricultural subsidies, perhaps it is time to gradually withdraw these subsidies and replace them with a solidarity surcharge for supporting the euro.[9]

Without political actors specifying a feasible and desirable destination for the Eurozone and a roadmap to get there, Europe will continue to face the risk of high government bond risk-premiums for many countries and an increasing need for internal devaluations that involve significant social costs and lead to political tensions. Having given up currency flexibility, it is essential those countries undergoing tough fiscal adjustments and long-overdue structural reforms are able to refinance themselves at sustainable interest rate levels. The European Central Bank cannot be expected to permanently engineer lower interest rates. It can and has provided immense liquidity that has bought valuable time. But it can only buy time. It too needs its political partners to complete the Eurozone's architecture. Rome was not built in one day, nor was the current level of European integration. In the same way a lighthouse enables a ship's captain to navigate a dark and stormy ocean, specifying the destination will better equip European economies to raise capital and facilitate their journey towards higher growth, financial stability and debt sustainability.[10]

9 El-Erian (2012).
10 Compare: El-Erian (2012).

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6. The Politics of Debt and Debt Crises

Ugo Panizza[1]

6.1. Introduction

This note discusses the links between debt and politics under three different states of the world. It starts with a short discussion of the politics of debt in tranquil times and points to political failures that lead to excessive debt accumulation through irresponsible fiscal policy. However, it also emphasizes that debt accumulation does not always have a fiscal origin. Next, the note discusses the politics of debt during liquidity crises with special emphasis on the behavior of creditor countries. Finally, the note discusses sovereign defaults and argues for the creation of a structured mechanism for the resolution of sovereign defaults.

The objective of the note is to be provocative and to challenge some commonly held views on the origin and resolution of debt crises.

6.2. Debt and Politics in Tranquil Times

A benevolent social planner with full information would never run an irresponsible fiscal policy and accumulate excessive debt[2]. Irresponsible fiscal policies are thus due to a misalignment between political incentives and society's objective function. Such misalignment, in turn, is rooted in a series of political failures.

6.2.1. The Political Economy of Debt Accumulation

The first political failure relates to the *common pool problem*. Fiscal policy is the outcome of a collective process that includes a variety of actors, each with his or her own motivations and incentives. The redistributive nature of fiscal policy may create incentives to overspend because those who enjoy the marginal benefit of an additional unit of public expenditure are different from those who bear the marginal cost of funding this extra unit. The presence of *concentrated interests* amplifies the common pool problem. When policy actions benefit a certain group

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1 This note summarizes a presentation delivered at the 2012 SUERF/OeNB Workshop titled "The Interaction of Political, Fiscal and Financial Stability: Lessons from the Crisis", and held at the Oesterreichische Nationalbank, Vienna on 18 June, 2012. I would like to thank the conference organizers for their invitation and conference participants for useful comments and discussion. The views expressed here are my own and do not necessarily represent those of the United Nations. This note is the condensed version of a longer paper titled "The Origin and Resolution of Debt Crises. It is Not Always Fiscal!" and draws on joint work (quoted in the text) with Eduardo Borensztein, Camila Campos, Dany Jaimovich, Eduardo Levy Yeyati, and Yuefen Li.

2 In an uncertain world, excessive debt could result from unexpected shocks. However, countries could buy insurance against these shocks.

and are funded with a general tax, the relatively small group of people who benefit from the policy will have strong incentives to lobby (though political donations, strikes, demonstrations, etc.) in favor of the policy. The much larger, but dispersed, group of actors that bears the cost of this action will have less incentive to act against it. The third political failure is due to *short-termism* arising from the fact that, while a social planner needs to evaluate the costs and benefits of a policy action over an infinite horizon, self-interested policymakers tend to have a finite horizon, which coincides with their expected term in office. As debt accumulation allows postponing the costs of public expenditure or tax cuts, self-interested politicians who give excessive weight to the immediate benefits of their actions have an incentive to run fiscal deficits and accumulate debt. Lack of transparency amplifies these political failures as it allows self-interested policymakers to hide their actions and dishonest politicians to embezzle public funds.

While it is impossible to transform self-interested politicians into benevolent social planners, there is a well established empirical literature that shows that certain budgetary institutions and procedural rules can help in yielding more prudent fiscal policies[3]. For instance, hierarchical rules that give more agenda-setting power to the prime minister or to the minister of finance and leave less autonomy to spending ministries are usually associated with better fiscal outcomes. Deficits and excessive debt accumulation can also be limited by introducing explicit fiscal targets. Balanced budget laws, or rules that cap deficits at a certain level are likely to be counterproductive, as they may end up amplifying a country's business cycle. However, smart budget rules that target a structural measure of the budget balance have proven to be helpful in stabilizing the economy and avoiding excessive debt accumulation. Nevertheless, rules are not always enforced and can be circumvented with creative accounting and various window-dressing techniques. As consequence, a successful fiscal policy also requires transparency rules that increase information flows, and are a necessary condition for the effectiveness of other budgetary institutions and procedural rules.

6.2.2. It's not Always Fiscal!

While budgetary institutions and procedural rules that reduce politicians' incentives to overborrow are certainly a good idea, debt crises are *not* always rooted in fiscal misbehavior. This seems a puzzling statement because in our first course of economics we learned that the change in the stock of debt is equal to the budget deficit (formally: $DEBT_t - DEBT_{t-1} = DEFICIT_t$) and that the stock of debt is equal to the sum of past deficits. However, those who work with actual debt and deficit data know that the change in debt is rarely equal to the budget deficit. A

[3] For a detailed discussion, see E. BORENSZTEIN, E. LEVY YEYATI and U. PANIZZA (2006), *Living with Debt*, Harvard University Press for the Inter-American Development Bank.

more appropriate equation for the change in debt is the sum of the deficit and an unexplained residual: $DEBT_t - DEBT_{t-1} = DEFICIT_t + SF_t$. In this equation, *SF* stands for stock-flow reconciliation; a cumbersome name that comes from the fact this residual entity reconciles a flow variable (the deficit) with a stock variable (the debt). I like to call the stock flow reconciliation the *unexplained part of public debt.*

Why am I getting so worked up with the unexplained part of public debt? It is not surprising that the change in debt=deficit identity never holds in practice. Debt and deficit data come from different sources, calculating them requires some approximations, and they are subject to measurement error. It would be surprising if we were to find that the change in debt is equal to the deficit. However, if measurement error were the only problem, we should find fairly small values of the unexplained part of debt. Moreover, since positive errors tend to compensate negative ones, we should also find that, when averaged over long periods of time, SF is equal to zero. In this case, the textbook identity $DEBT_t - DEBT_{t-1} = DEFICIT_t$ would be a good approximation for the main drivers of debt accumulation.

In joint work with Camila Campos and Dany Jaimovich we show the unexplained part of debt is far from being a small residual entity. Using a large sample of developed and developing countries, we find that deficits explain a small share of the variance of debt and that, over a long period of time, the unexplained part of debt averages to about 3-5 percent of GDP per year[4].

After having established that there are large differences between deficits and changes in debt, the paper with Campos and Jaimovich also explores the determinants of the unexplained part of debt by concentrating on three groups of variables.

The first set of variables aims at capturing balance sheet effects due to the interaction between currency depreciations and the presence of foreign currency debt. The idea is that currency devaluations should lead to large stock-flow reconciliations in countries with high levels of foreign currency debt.

The Argentinean crisis of 2001/2002 is an example of the importance of balance sheet effects. In the ten years preceding the default, Argentina ran a fairly moderate fiscal policy. The average deficit was 1.2 per cent of GDP and, even in the deepest year of the crisis, Argentina's deficit was below 3 per cent of GDP. Debt levels were also fairly low, about 55 per cent of GDP in 2001. Over 2001 and 2002, Argentina ran an average budget deficit of less than 3 percent of GDP, but the Argentinean debt-to-GDP ratio went from approximately 55 per cent in 2001 to 150 percent in 2002. As about half of the country's public debt was denomi-

4 C. CAMPOS, D. JAIMOVICH, D. and U. PANIZZA (2006), "The unexplained part of public debt", *Emerging Markets Review*, vol. 7(3), pp. 228-243.

nated in US dollars, when Argentina abandoned its dollar peg and the exchange rate went from one peso to one dollar to four pesos to one dollar, the local currency value of the dollar denominated debt quadrupled. In this case, the debt crisis was not due to an irresponsible fiscal policy but to the presence of foreign currency denominated debt and an overvalued currency.

In our econometric analysis, we find that a real depreciation of 30 percent has no effect on the stock-flow reconciliation in countries with no foreign currency debt. In countries with moderate levels of foreign debt, a similar devaluation leads to a difference between deficit and debt of approximately 3 percent of GDP. Finally, in countries with high levels of foreign currency debt (i.e., the top one third of the distribution), we find that a 30 percent depreciation is associated with a stock flow reconciliation which is equal to 10 percent of GDP.

The second set of variables of our econometric analysis aims at capturing the effect of the resolution of sovereign default episodes. As default episodes lead to partial debt cancellation, we find that defaults are associated with negative stock flow reconciliations.

Our third set of explanatory variables concentrates on banking crises. These are important events because they generate a series of contingent liabilities and other off-balance sheet activities that can then lead to debt explosions (the recent experiences of Ireland and Spain are two examples of the link between banking crises and debt explosions). Our statistical model shows that the average banking crisis is associated with a stock-flow reconciliation of almost 3 percent of GDP.

While these are interesting results that suggest that building a safer debt structure and implementing policies that can limit the creation of contingent liabilities are key to avoiding debt explosions, the above variables only explain 20 percent of the variance of the stock-flow reconciliation. There is still a lot that we do not understand about the non-fiscal origins of debt crises[5].

6.3. Debt and Politics during Liquidity Crises

In order to discuss the politics of debt crises, we need to differentiate between solvency and liquidity crises. Solvency is not well defined in the case of sovereign debt. Government assets such as future ability to tax and the country's territorial integrity do not have a well defined market value and cannot easily, and probably should not, be handed to creditors. Moreover, governments are not expected to stop providing basic social services, disband the military, or stop running their

5 The above discussion is based on Chapter 3 of E. BORENSZTEIN, E. LEVY YEYATI and U. PANIZZA (2006), *Living with Debt*, Harvard University Press for the Inter-American Development Bank.

foreign policy in order to honor their debts. As a consequence, sovereign solvency is an elusive concept.

This section concentrates on liquidity crises, concerning countries which are fundamentally solvent but have lost market access and, in the presence of multiple equilibria, could become insolvent if they are not supported by an international lender of last resort. Rather than discussing politics in the crisis country, I will concentrate my discussion on the politics of international 'rescue' packages.

Packages normally have three characteristics: (i) they are conditional to a process of fiscal consolidation; (ii) they offer a limited amount of money (i.e., international lenders of last resort do not lend at will) which is disbursed in tranches, and only if the crisis country meets the package's conditionality; and (iii) they carry interest rates which are higher than the opportunity cost of funds.

I will argue that, in certain cases, this approach to crisis management is not dictated by sound economics but by political considerations.

6.3.1. Fiscal Consolidation

Fiscal consolidation is clearly necessary for countries that got into trouble because they ran an irresponsible fiscal policy. However, in the previous section we saw that many debt crises do not have a fiscal nature. Consider the case of Spain. Over 2000-2007, Spain had an average budged surplus of approximately 0.4 per cent of GDP (for comparison, over the same period, Germany had an average budget deficit of 2.4 per cent of GDP). If we focus on the primary budget balance, which is the only variable under partial control of the fiscal authorities, we find that Spain had a surplus of 2.7 per cent of GDP (for reference, Germany had primary surplus of 0.7 per cent of GDP). Not only Spain's actual balance was in surplus, but so was its structural balance. Independent IMF estimations based on the information available in April 2006 suggested that Spain was running a large structural fiscal surplus, and that the country would have kept running structural surpluses until the end of the estimation period.

It is seems thus clear that Spain did not get into troubles because of an irresponsible fiscal policy. And yet, fiscal consolidation is very much at the center of the Troika package. Why is it so? One possible answer is that, since debt dynamic depends on the level of debt, a fiscal stance that used to be sustainable is no longer so.

To see if this point holds water let us forget the stock-flow reconciliation and consider the standard debt-dynamic equation stating that the change in the debt-to-GDP ratio (d) depends on the primary balance (pb) and on the debt-to-GDP ratio multiplied by the difference between the interest rate (i) and the economy's growth rate (g):

$\Delta d = -pb + (i - g)d$

Now, let us consider a country with a structural primary budget surplus of about 2.5 per cent of GDP, an interest rate of 3 per cent, a growth rate of 2 per cent and a debt-to-GDP ratio of 50 per cent. This country is clearly in a fiscally sustainable situation, as the debt-to-GDP ratio is decreasing by approximately 2 percentage points per year $(-2.5 + (3-2) * 0.5 = -2)$.

Now, let us assume that this country's debt-to-GDP ratio suddenly doubles (perhaps because the government needs to bail out the banking sector) to 100 per cent. Other things equal, this sudden jump in debt does not bring the country towards an unsustainable situation (the debt-to-GDP ratio would still be decreasing by approximately 1.5 percentage points per year: $(-2.5 + (3-2) * 0.5 = -2)$. However, things might have changed because the sudden jump in debt has an effect on the other variables that enter in the debt-dynamic equation. While, with an unchanged fiscal stance, an increase in debt should have no effect on the primary structural balance, the sudden increase in debt may have a positive effect on the interest rate and a negative effect on long run growth.

Let us consider these effects one at a time and start by thinking how the jump in debt may affect the interest rate. There is no consensus on the interest rate effects of public debt levels. On the one hand, Japan and the current cases of the United States and the United Kingdom indicate that debt levels have no effect on long-term interest rates. On the other hand, the euro crisis points to a tight correlation between interest rates and debt levels in countries in the European periphery[6]. Recent estimates suggest that, in advanced economies, a 1 percentage point increase in the debt-to-GDP ratio may increase long run real yields by about one basis point[7]. Therefore, a 50 percentage point increase in the debt-to-GDP ratio may lead to a half a percentage point increase in the long-term real yield of public debt.

The effect of public debt on GDP growth is also a hotly debated topic. While Stephen Cecchetti, Madhusan Mohanty and Fabrizio Zampolli find that a 10 percentage point increase in the public debt-to-GDP ration leads to a 17 basis points decrease in long-run growth, my own research with Andrea Presbitero finds no causal effect of public debt on growth[8].

6 However, this effect seems to be due to differences in labor productivity and market liquidity. The effect of public debt appears to be negligible. P. ALESSANDRINI, M. FRATIANNI, A. H. HALLETT and A. PRESBITERO (2012), "External imbalances and financial fragility in the Eurozone", *MoFiR working paper* No. 66.

7 L. FORNI and E. ALPER (2011), "Public Debt in Advanced Economies and its Spillover Effects on Long-term Yields", *IMF Working Papers* 11/210.

8 S. CECCHETTI, M. MOHANTY and F. ZAMPOLLI (2011), "The real effects of debt", *BIS Working Papers* No. 352; U. PANIZZA and A. F. PRESBITERO (2012), "Public Debt and Economic Growth: Is There a Causal Effect?", *MoFiR working paper* No. 65.

To be on the safe side, let us now assume that public debt does have a positive effect on yields and a negative effect on growth. If we use the ballpark estimates mentioned above to calculate the interest rate and growth effect of a 50 percentage point sudden jump in debt in the hypothetical country mentioned above, we find that the long term real interest rate would increase by 50 basis points (to 3.5 per cent) and long run growth would decrease by 85 basis points (to 1.15 per cent). The difference between long run interest rate and long run growth would thus increase from 1 per cent to 2.35 per cent. If we substitute these numbers in the debt dynamic equation, we find that, even with this extreme scenario which involves a doubling of the debt-to-GDP ratio and large effects on both interest rate and GDP growth, the country would still have a declining debt-to-GDP ratio with unchanged fiscal policy.

Of course, in the short run, the debt-to-GDP ratio may be increasing because, if the jump in debt happens during a recession, growth will be below trend and the actual budget balance will be smaller than the structural balance. However, fiscal and debt sustainability need to be assessed over the long run. In the long run, even with extreme assumptions on the effects of debt on growth and the interest rate, a country which, like Spain, had a strong fiscal position before the crisis, will still have a sustainable fiscal position even after an enormous increase in its debt-to-GDP ratio.

In fact, a rapid fiscal adjustment can have a negative effect on debt sustainability because it may reduce growth not only in the short run but, through hysteresis and its negative effect on public investment, also in the long run[9]. Moreover, rapid fiscal adjustments can be dangerous even when the crisis did have a fiscal nature. Carlo Cottarelli, who is the head of the IMF Fiscal Affairs Department and certainly not a fiscal dove, made this point in a recent article in which he stated that fiscal adjustment should proceed at steady but moderate pace[10]. Another problem with rapid, externally imposed, fiscal adjustments relates to the risk that the adjustment will be reversed as soon as the crisis country no longer needs emergency lending. Slower reforms, adopted with national consensus, are more likely to stick.

6.3.2. No Big Bazooka and High Interest Rates

Crisis packages do not usually come with a big bazooka. The amount of money is limited, disbursed in tranches, and the disbursements are conditional to, usually

[9] For a discussion of the first effect see: B. DELONG and L. SUMMERS (2012), "Fiscal Policy in a Depressed Economy", *Brookings Papers on Economic Activity* and for an analysis of the second effects see: W. EASTERLY, T. IRWIN and L. SERVÉN (2008), "Walking up the Down Escalator: Public Investment and Fiscal Stability", *World Bank Research Observer*, vol. 23(1), pp. 37-56.

[10] C. COTTARELLI (2012), *The austerity debate: Festina lente!*, http://voxeu.org/article/austerity-debate-make-haste-slowly.

overoptimistic, fiscal targets. This strategy is normally justified by the needs to guarantee that the crisis country will respect the conditions of the package and to protect the taxpayers of the countries that finance the package. However, if fiscal targets are overoptimistic and self-defeating, and if the likelihood of the success of the package depends on market confidence, such strategy may end up being self-defeating. Conditionality may amplify the recessions, increasing the likelihood that the country will miss the fiscal target, and uncertain disbursements may spook markets and thus reduce the likelihood that the country will regain market access. In other words, this strategy may backfire and, therefore, increase the risk that the package will not be successful and that the lending countries will not be able to recover the funds they lent.

Crisis packages usually come with interest rates which are well above the opportunity costs of funds for the lending countries. Therefore, while crisis packages do not usually follow Bagehot's suggestion of lending liberally, they do follow Bagehot's suggestion of lending at a punitive rate. Also in this case, the strategy may backfire. The debt sustainability equation specified above shows that debt sustainability is negatively correlated with the interest rate. Therefore, instead of protecting taxpayers in the lending countries, high interest rates may increase the probability that the crisis country will not repay, and cause large losses for the taxpayers in the lending countries.

It is sometimes argued that crisis packages with high interest rate are needed to prevent moral hazard. It is however hard to think that there is a moral hazard problem in the middle of the crisis, when politicians try to fight the crisis with actions that reach new limits in what is politically feasible. Believers in the moral hazard theory of high interest rates may think that the fear of high interest rates at times of crisis will discipline politicians during good times. While it is easy to formalize this view in a theoretical model with forward-looking politicians, it is unlikely that the threat of high interest rates during bailouts will discipline real-world policymakers with a short-term political horizon. As Governor Nowotny stated in his opening remarks. We should not be too afraid of moral hazard.

6.3.3. Is Bad Economics Good Politics?

Why are crisis packages often based on bad economics? Probably because bad economics can be good politics. Paul Krugman has argued that it is "...normal to think of economics as a morality play, a tale of sin and redemption, in which countries must suffer for their past excesses"[11]. As the morality play sells well and it is easy to explain to the public, policymakers are often under strong political

[11] http://krugman.blogs.nytimes.com/2012/03/05/economics-in-the-crisis/.

pressure to be 'tough' with countries that are under market pressure. Politics dictates that countries that receive exceptional finance need to adjust their policies. They need to suffer for their presumed sins, even if these adjustments and sins have nothing to do with the crisis that it is affecting the countries.

6.4. The Politics of Sovereign Defaults

Standard models of sovereign debt assume that countries have an incentive to default too much or too early and that their desire to default is only restrained by the high costs of a sovereign default. However, it is hard to find evidence on the costs of sovereign default. In fact, there is evidence that these costs are often paid *before* the default decision is made[12]. This finding challenges the standard assumption about the optimal time of default. If the default decision entails a tradeoff between the burden of servicing the debt (which grows as the crisis deepens), and the additional cost of default (which declines as the crisis takes its toll), the absence of observed costs is an indication that defaults are often deferred for too long[13]. This effort to postpone a default that has been widely anticipated and priced in by the market may lead to a destruction of value because the protracted pre-default crisis reduces both capacity and willingness to pay. Delaying default might be costly for at least three reasons: (i) Non-credible restrictive fiscal policies are ineffective in avoiding default and lead to output contractions; (ii) Delayed defaults may prolong the climate of uncertainty and high interest rates and thus have a negative effect on investment and banks' balance sheets; (iii) Delayed default may have direct harmful effects on the financial sector.

Why do policymakers tend to delay necessary defaults? There are two possible answers to this question. The first answer has to do with self-interested politicians who want to protect their jobs. A politician concerned about his/her political survival faces a tradeoff that is somewhat different from the one affecting the representative citizen. As there is evidence of high political turnover following a debt default, self-interested policymakers may try postponing defaults, even if this entails an economic cost for society at large.

An alternative explanation is that well-intentioned policymakers postpone defaults to ensure that there is broad market consensus that the decision is unavoidable and not strategic. This would be in line with economic models that assume that sovereign debt contracts include an implicit clause that justifies 'nec-

12 E. Levy Yeyati and U. Panizza (2011), "The elusive costs of sovereign defaults", *Journal of Development Economics*, vol. 94(1), pp. 95-105.

13 K. Rogoff and J. Zettelmeyer (2002), "Bankruptcy Procedures for Sovereigns: A History of Ideas, 1976-2001", *IMF Staff Papers*, vol. 49(3), pp. 8-23; E. Borensztein and U. Panizza (2009), "The Costs of Sovereign Default", *IMF Staff Papers*, vol. 56(4), pp. 683-741; U. Panizza, F. Sturzenegger and J. Zettelmeyer (2009), "The Economics and Law of Sovereign Debt and Default", *Journal of Economic Literature*, vol. 47(3), pp. 651-98.

essary' defaults[14]. In such a set up, 'strategic' defaults are very costly in terms of reputation – and that is why they are rarely observed in practice – while 'unavoidable' defaults carry limited reputation costs in the markets. Given that there is no clear criterion for separating strategic from unavoidable defaults, policymakers may decide to postpone a needed default and inflict great pain to the country in order to signal that default is indeed unavoidable.

This behavior, in which politicians choose the lesser of two evils, is a second best solution to a situation in which policymakers optimally respond to a distortion (lack of enforceability) with another distortion (delayed default). However, if the need of signaling good faith is indeed the reason for delayed defaults, there are policy options that could move the situation from a second to a first best. A credible sovereign insolvency mechanism, with the ability of establishing and certifying ability to pay, could solve the signaling problem and, by avoiding sub-optimally delayed defaults and preventing protracted pre-default crises, increase recovery value. The mechanism would thus be efficient both ex-ante, because the increase in recovery value would lower sovereign spreads, and ex-post, as it would lead to a quicker and less painful resolution of sovereign defaults.

14 H. GROSSMAN and J. VAN HUYCK (1988), "Sovereign Debt as a Contingent Claim: Excusable Default, Repudiation, and Reputation", *American Economic Review*, vol. 78(5), pp. 1088-97.

7. What is special about the Debt Crisis in the Euro Area?

Elga Bartsch[1]

This note summarises and updates remarks I made at a recent conference jointly organized by SUERF and the OeNB in June 2012. At the conference, my co-panelists and I discussed what makes the euro area sovereign debt crisis special. My main conclusion was that **what makes the euro area sovereign debt crisis special is the absence of a 'lender of last resort' for governments**. This is because, in my view, unsound fiscal fundamentals and protracted political deadlocks can also be found in the other developed market economies, e.g. in the US, the UK or Japan. Yet, these other developed market economies countries have been able to fund themselves at very affordable rates throughout the crisis. While there are a number of important differences between the euro area and these countries, in my mind, the monetary backstop is what makes the very difference.

Clearly, the **institutional set-up of the euro area is unique**; it being a common currency without a fiscal union, without a banking union and without a political union – at least thus far. Furthermore, the euro as a common currency is a relatively recent endeavour and some of the current concerns could also reflect a one-off adjustment caused by the arrival of the new currency. In addition, its institutional underpinnings are still evolving. Finally, investors continue to question the irreversibility of the euro as a common currency; concerns that are also fuelled by ill-advised comments from politicians both in the core and in the periphery on a possible exit of Greece from the common currency.

But the most important factor, in my view is the lack of a lender of last resort for euro area sovereign states. As I explain below, **while PSI in the context of the second rescue for Greece has likely been a contributing factor, it is not the root cause** for many euro area government bonds increasingly being viewed as credit risks by investors. Neither is the seniority of the ECB in that particular restructuring or the seniority of the ESM for that matter. As the result of this shift in investor perception, several government bond markets in the euro area periphery have lost their status as safe-haven assets. The process has started well ahead of the PSI decision. The mounting credit concerns caused funding costs in some euro area countries to spike. This regime shift effectively deprives several euro area governments of their ability to stabilize their economy and to backstop their bank systems. To fully restore confidence in euro area government bond markets as

[1] Paper presented at the SUERF Conference "Interaction of Political, Fiscal and Financial Stability: Lessons from the Crisis", June 18, 2012.

safe haven assets thus requires more than 'just' a banking union and a fiscal union. It will require a lender of last resort: the ECB, directly or indirectly via the ESM.

The existence of a lender of last resort is the key re-insurance mechanism that **removes credit risk from sovereign borrowing even in the extreme situations**. Note that I am not arguing in favour of monetizing government debt. On the contrary, I continue to worry that inflation is much more serious long-term risk than, say, deflation. What I am arguing for is an institutional set-up, which ensures the safe-status of government bonds. A precondition for such a lender of last resort function is strict fiscal discipline on the part of all euro area countries. Without a lender of last resort, euro area countries would essentially borrow like emerging market economies, i.e. borrow in a currency that they cannot print.

As a result, the long-term **debt level that investors are ready to tolerate is considerably lower than what most euro area countries are sporting today**. In fact, it would also be considerably below the 60% debt-to-GDP threshold envisaged in the Stability and Growth Pact. Furthermore, as the history of sovereign debt crisis in emerging markets shows, wild swings in borrowing costs are a frequent occurrence as bond markets have a tendency to overprice the probability of a default by a considerable margin. As a consequence, fiscal policy will often become procyclical as governments are often forced to tighten aggressively in a downturn.

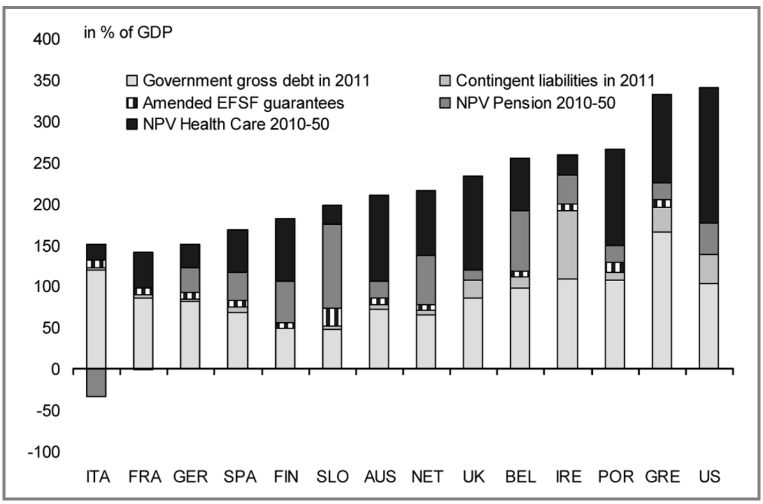
Currently, the **ECB acts as a lender of last resort for banks**. But the EU Treaty bans it from lending to governments in the course of its normal operations. But the lack of a lender of last resort is the main reason, I think, why **Europe struggles to fund at low rates while US, UK and Japan don't**. In my view, it is the potential recourse to central bank funding that sets government bonds apart from other forms of borrowing. It is what makes government bonds credit risk-free assets. The absence of credit risks in the perception of the financial markets is essential for any government to be able to perform its key function in stabilising the economy over the course of the cycle and backstopping the financial sector in times of crisis. Governments can perform these functions if and only if they are able borrow at low rates at the bottom of the business cycle and at the height of financial market anxiety.

As governments in the euro area don't have direct recourse to central bank liquidity, **credit concerns caused a fundamental change the behaviour of an increasing number of national government bond markets in the euro area**. A rising number of peripheral economies in the euro area are essentially operating in a post-Keynesian regime where they are no longer able to back stop their economies or their banks. Instead government bond markets seem to have become highly unstable and subject to multiple equilibria, some of which seem to very undesirable in terms of the economic, political and social costs implied some of the possible outcomes.

Unfortunately, **even a full blown fiscal union and the fully fledged banking union will not be able to put this market instability to rest completely.** Further fiscal integration in the euro area up to and including joint issuance of euro bonds, would only allow pooling the (credit) risks. Such a pooling of the credit risks across the euro area should also help reduce them – provided that joint issuance happens under an appropriate institutional framework that prevents moral hazard and provided that the existence of a new joint debt instrument does not trigger a series of defaults on the legacy debt issued at the national level.

The joint issuance of euro bonds could help pool individual country credit risks and, depending on their liability structure, could provide a certain guarantee structure for investors. Contrary to the bonds issued by the EFSF, which only carry a pro-rata liability, almost all euro bond proposals are advocating a joint liability of all euro area countries for at least part of the debt stock. The inherent risk in such a structure is that it has a high propensity to create moral hazard and hence could lead to large scale fiscal transfers – such as the German *Laender-finanzausgleich*.

Exhibit 1. Public Finances at a Glance

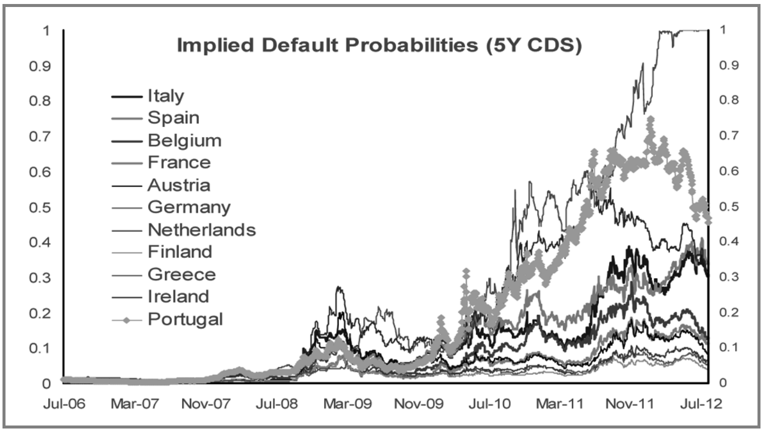


Source: Eurostat, IMF, CBO, Morgan Stanley Research.

In my view, **a banking union and a fiscal union enforcing financial prudence and fiscal discipline are a precondition to make the ECB a lender of last resort for governments** – with a view to minimise the use of this reinsurance mechanism and to limit it to the most extreme situations. In my book, other developed market economies don't fund more cheaply than euro area governments, because they have sounder fiscal fundamentals. Exhibit 1 shows that they don't. Other developed market economies fund more cheaply than countries in the euro area periphery because bond investors don't loose sleep over getting their money back when the government bonds mature. Instead investors assume that, if needed, the money will simply be printed.

Over the last three years, we have seen **re-rating** of the market perceptions of euro area sovereign credit risks. Today, I would argue, some euro area government bond markets significantly overestimate the sovereign credit risks in the euro area. However, what's more, we have observed a fundamental regime shift in government bond markets. Rather than viewing government bonds as risk-free, safe-haven assets, financial markets now view and trade several euro area sovereigns mainly as credit risks. Discussions of possible haircuts, creditor seniority etc has become all the rage amongst investors. This has very profound consequences for the stability of financial markets.

Exhibit 2. Implied Default Probabilities in the Next Five Years



Source: Morgan Stanley Research.

For it seems that some peripheral government markets have lost their ability to find a new, stable **equilibrium**. This is because, instead of moving in sync with the business cycle, government bond yields now move against the cycle, i.e., they rise in a downturn. This seriously undermines the ability of the government sector to stabilize the economic cycle and the financial sector. The inherent market instability casts some serious doubts about whether markets should be relied upon as a disciplining factor in the fiscal surveillance of euro area member states.

Private sector involvement (PSI) as well as treating the ECB as a senior vis-à-vis private sector investors was an exacerbating factor. But, in my view, it is not the root cause. PSI was a contributing factor – acting as a fire accelerant fuelling the contagion – but it is not the root cause. Euro area government bond markets switched to the credit regime long before PSI was discussed in policy circles. But, PSI gave the official seal of approval to market expectations that restructuring of the Greek debt was unavoidable. While I actually believe that PSI is desirable to avoid moral hazard, the timing of introducing PSI in the midst of the crisis was clearly sub-optimal.

Each time, news on PSI seems to have reinforced **contagion** and triggered a further escalation of the sovereign debt crisis. Introducing PSI into the debate at the Franco-German summit at Deauville in October 2010 caused Italy and Spain's bond market to become more volatile. Introducing it explicitly into the ESM post 2013 in mid-December 2010 caused a further escalation in market tensions in these two countries. Effectively, a haircut that will hardly make a dent in the Greek debt burden has undermined financial stability in the euro area as a whole by tainting an entire asset class – euro area government bonds. Given the u-turns that we have seen on the PSI issue, markets assign little credibility to the political commitment that Greece will remain an exception.

I therefore believe that the root cause is the absence of a lender of last resort to governments. As individual euro area countries do not have access to a central bank as lender of last resort, all member states' debt instruments are effectively **credit risks.** True, the bond markets do not view all countries in this way (yet). Germany, at least for now, still seems to be benefitting from a safe haven status. But, this assessment could tilt very quickly if, for instance, Germany and other core countries signed up for ever-larger rescue mechanisms. The absence of a lender of last resort – which, of course, is ruled out by the European Treaty – also implies that even moving towards a fully integrated fiscal union would not remove the credit risk completely (see *EuroTower Insights: Fiscal Union Needs Monetary Back-Up to Solve Crisis*, September 22, 2011). The feature that sets sovereign debt apart from other forms of debt is the unlimited recourse to the central bank as a lender of last resort. This recourse ensures that even in extremely distressed situations government bond investors can rest assured that they will be paid back at par. This is what makes government bonds **safe-haven assets.**

Once aware of the credit risks, financial markets have a tendency to significantly **overprice the default risks**. Looking at the experience of emerging markets, where we have a sufficient number of empirical observations, we find that in all the cases since the mid-1990s where spreads blew out to more than 1,000bp, in only 20% of cases did a debt restructuring really become necessary to restore debt sustainability. The other 80% of countries actually pulled through without any debt restructuring – though often with the help of an IMF programme (see C. Cottarelli *et al.* (2010), *Default in Today's Advanced Economies: Unnecessary, Undesirable, and Unlikely*, IMF Staff Position Note No. SPN/10/12).

There are good reasons why the market overprices the risk of default: Defaults are highly disruptive, binary events, which potentially have a big impact on portfolio performance. Around a default, you typically see very sizeable non-linear market reactions, as market liquidity tends to dry up almost completely. Clearly, an unexpected default can also be very detrimental for the career of a portfolio manager who was not mandated to take such credit risks. The **steady creep of inflationary pressures**, by contrast, **is a risk that bond markets typically underestimate**. You could even say that inflation is a bit of blind spot for the bond market. Default, by contrast, seems to be a hot button for the bond market.

This is why **market discipline does not work in practice**. The first attempt with the original Stability and Growth Pact clearly failed to establish fiscal discipline. Market discipline did not work either and we are starting to doubt whether it would ever work.

What we observe in euro area government bond markets at the moment is more than just an overshoot in the market's perception of the default risks. The regime shift from risk-free sovereign debt to credit risk makes government bond markets highly unstable, unable to find a new equilibrium. **Bond yields start to move in counter-cyclical fashion:** additional austerity efforts which dampen growth cause bond yields to go up rather than down on the back of the perceived increase in the risk of default. The rising bond yields in turn reduce the sustainability of government debt. Fresh concerns about debt sustainability cause a further rise in bond yields. Sprinkle in a few rating agencies re-running their models with the higher bond yields and concluding that a downgrade is (or will soon be) warranted on the back of a deterioration of debt sustainability, and a vicious circle is set into motion.

Hence, rather than exercising market discipline, markets are likely to push towards a **sub-optimal equilibrium** where even runs on governments are possible. As a result, even solvent governments can become illiquid very quickly. In my view, no euro area country is safe from the regime shift towards credit. We have seen the sovereign debt crisis meandering around the euro area for more than two years now, and eating its way deeper and deeper into the core of the euro area.

Once this vicious circle is in motion, **only outright market interventions can restore stability**. Here the SMP has forced the ECB onto a very slippery slope. Given the statutory limitations on the operations of the ECB/EFSF, it is very difficult, if not impossible, to simply switch back into safe haven mode. Even Mario Draghi's Master Plan outlined at the August ECB press conference, which will likely see the ECB intervening in government bond markets alongside the

EFSF/ESM this fall, is unlikely to be fully switch government bonds back into safe haven modus. This is not so much because the market intervention itself is conditional on the existence of EFSF/ESM support, but because the ECB's market intervention will be limited to the short-end (see ECB Watch: Mario's Master Plan, August 5, 2012).

Many investors and policy makers seem to pin their hopes on the sovereign debt crisis being resolved by a swift move towards a closer **fiscal union** and the start of a **joint issuance** of euro bonds. Notwithstanding the political and legal hurdles to such a *quantum leap*, we believe that even a fiscal union and joint bond issuance would probably not be enough to fully resolve the euro area sovereign debt crisis. Clearly, a fiscal union ensuring strict fiscal discipline is a necessary condition for overcoming the current crisis and for improving on the current situation. However, an end to the crisis is unlikely without an unlimited lender of last resort. The discussion about a closer fiscal union marks a continuation of the piecemeal approach that has characterised how Europe has dealt with the crisis so far.

But without a monetary backstop, euro area government bonds will not be considered risk-free assets again any time soon.

From a market point of view, it is the **government's recourse to the central bank's printing press that separates sovereign debt from other forms of debt.** Otherwise solvent governments can experience self-fulfilling runs on their debt if they don't have recourse to the central bank as a lender of last resort. If designed properly, the monetisation of government debt would be a reinsurance mechanism that in actual fact would never be used. We recognise the risks of governments who are unwilling to adhere to fiscal discipline shifting their fiscal responsibilities to the central bank. This is exactly what we have been witnessing in the euro area – where both governments in the periphery and in the core have been relying on the ECB to save the day.

In developed market countries issuing debt in domestic currency, recourse to the central bank's printing press acts as an **insurance against a vicious cycle in market sentiment**. In the euro area, the monetisation of government debt would mark another step change in the policy response – one that would be even more controversial politically and legally than the creation of a fiscal union and joint issuance of euro bonds.

Hence, eventually the policy debate needs to be about the monetisation of government debt via a democratically mandated backstop. At present, the ECB is being forced onto a slippery slope by European governments, who are delaying addressing both national economic policy reforms and institutional innovations to the governance of the euro area as a whole. The ECB has been forced to take unprecedented financial and political risks with its various open market operations ranging from its unlimited refinancing operations to its securities market programme (SMP). Eventually, the situation with the ECB's **Securities Market Programme (SMP)** had become untenable.

In my view governments need to be clear about how they intend to relieve the ECB of its temporary task (and when) or whether they intend to explicitly amend the ECB mandate to include a lender of last resort function. The present muddling-through is the worst of all options. Policy makers should be aware that the **ECB's SMP transforms national government debt into a common euro area liability**. From a governance point of view, it would be much better if this transformation would take place on the EFSF/ESM balance sheet, where national parliaments can exercise their democratic control function.

More than many lawmakers and the public at large might realise, a **quasi-fiscal union** is currently being created through these open market operations on the rapidly growing ECB balance sheet. Not only does the SMP blur the responsibilities between fiscal and monetary policy without there being a clear legal and institutional framework in place, but also national sovereign debt is being transformed into a pan-euro liability at a fast pace on the ECB balance sheet. In our view, this grey area of unprecedented crisis management needs to be clarified urgently by European governments and put to vote in democratically elected parliaments. Otherwise, we see a serious risk of an undermining of the effectiveness and credibility of one of the very few European institutions that have proven to be fully functional: the European Central Bank.

The slower governments are in bringing about a *quantum leap* in euro zone governance, the more joint financial risks will likely end up on the ECB balance sheet and the closer we get towards what is effectively **not just the mutualisation but also the monetisation of national government debt.** The ECB is being forced onto a very slippery slope given that its mandate also includes an obligation of help governments safeguard financial stability. Governments need to be clear whether they intend to relieve the ECB from its temporary task soon or whether they intend to amend the ECB's mandate to include a lender of last resort function. The present strategy of 'muddling-through' is the worst of all options.

The ECB's **SMP transforms national bond markets into a euro area common liability**, a liability that is backed by euro area governments via a loss-sharing agreement. This is obvious from the sterilisation of the SMP purchases. The ECB has several alternatives to sterilise its bond purchases: offering short-term deposits or issuing ECB debt certificates. Currently, the ECB is using short-term deposits to remove the liquidity added by the SMP's bond purchases from the interbank market. If the ECB instead decided to issue ECB debt certificates, it would be obvious that it is hoovering-up national government debt from the secondary market (rather than the interbank market) and transforming it into a euro security on its balance sheet. But this is not different for the short-term deposits it currently offers. Given that the short-term deposits are eligible collateral for the ECB's refi operation, they are quasi-money anyway.

From a governance point of view, it would be much better to do this transformation of national debt into euro area debt on the **EFSF or ESM balance sheet** where national parliaments exercise their democratic control function. In our view, it would make sense to consider leveraging up the rescue mechanism. The European Investment Bank, EIB, could be a blueprint, we think. Not only would the transformation of national sovereign debt into euro area wide debt no longer happen on the ECB balance sheet, but the ECB would also still have the discretionary decision as to whether it would make an ESM-bank an eligible counterparty to its repo operations. Like all other banks, the collateral that the ESM bank would post to the ECB (in particular the government bonds it bought in the secondary bond market) would be marked to market on a daily basis and be subject to the normal haircuts the ECB applies.

This would clearly offer the ECB much better protection against potential financial risks if the sovereign debt crisis escalated further than the SMP. The SMP purchases are accounted for at purchase costs as they are intended to be held until they mature. Hence, any loss in value of the government bonds purchased by the ESM-bank would immediately shrink the collateral pool. Even though this would not lead to direct losses at the ESM-bank, where the bonds would likely be held as hold-to-maturity assets, the ability of ESM-bank to fund might be affected, thus creating strong incentives for governments.

The monetisation of government debt via a state-owned bank will likely also be controversial on the ECB Governing Council. True, the ESM-bank can create additional liquidity, but that is not different from any other commercial bank that funds its government bond purchases at the ECB – a phenomenon that was widely observed after the ECB launched its first one-year tender and that we have always referred to as indirect QE. Short of a complete overhaul of the European Treaty to lift the ban on monetisation of government debt by the ECB alongside the introduction of a closer fiscal union – which would certainly require referenda in several countries and would likely irk the German Constitutional Court – using a levered form of the ESM to conduct purchases of government bonds in the secondary market would seem a viable second-best policy option.

True, such a **change of the EU Treaty**, which bans the ECB from funding governments, would likely be brought in front of the German Constitutional Court (where this challenge could have a higher chance of success than the cases brought recently given its Maastricht ruling in the early 1990s). Outright, unconditional monetisation of government bonds could pave the way for Germany and a few other core countries to begin contemplating leaving the euro in order to reinstate a hard currency regime. Hence, rigorous fiscal discipline is an even more pressing policy need. Given the tendency of elected governments to never consider it the right moment to rein in budget deficits and pay down debt, strict fiscal rules at the constitutional level would be essential.

The aversion to the monetisation of government debt in Germany likely runs much deeper than the inflation *angst* caused by the Hyperinflation of the 1920s. This aversion reflects the fact that the central bank printing press was used twice in the 20th century to fund major wars. After the Second World War, it was therefore decided that the predecessor to the Bundesbank should not take any instructions from the newly established West German government even though it was initially to be directed by the Allied Forces. Like the restrictions on other elements of the German constitution, e.g., its electoral system or the federal structure, banning the Bundesbank from funding the government was intended to limit a concentration and centralisation of power within the newly established Federal Republic.

The post-war *Wirtschaftswunder* caused the German population to become much more attached to their independent central bank than their elected governments. The hard currency regime that the Bundesbank provided resonated well with a population that has memories of hyperinflation and subsequent currency reforms. Thus, the desire to fiercely protect the independence of the central bank runs much deeper than just the inflation *angst*. In this context, Germany is probably a historical exception rather than the rule. Either markets never really understood that the Bundesbank was banned from monetising German government debt, or we were just lucky that we did not have a sovereign debt crisis during the reign of the Bundesbank.

To sum up, while policy makers presently worry about the appropriate design of a **fiscal union** to complement the banking union agreed on at the June EU Summit and whether and how to embark on **joint issuance of euro bonds,** my main concern remains that even a perfectly designed and implemented fiscal union and joint issuance of euro bonds might not be sufficient to end the sovereign debt crisis. This is because a fiscal union will only reduce the perceived credit risk, not remove it. To remove the credit risk (which seems to be causing unstable markets) and re-establish euro area government bonds as sovereign debt, the euro area will need to have a **backstop with unlimited capability to provide liquidity**. This can only be done by the central bank. Thus, a fiscal union is only a precondition for allowing the ECB to monetise government debt in extreme situations where ECB intervention is deemed the *ultima ratio*.

8. In the Debt Debate, our Sovereign Ratings have no Austerity Bias

Moritz Kraemer

Few economic controversies in recent decades have been as divisive as the current debate regarding the appropriate policy mix to lead the European Economic and Monetary Union (eurozone) out of its current financial and economic crisis. In essence, the question is this: Should governments make budgetary cuts an urgent priority in light of historically high public sector borrowing needs among advanced-economy sovereigns and limited market appetite to absorb rising debt? Or does austerity undermine a nation's growth, putting it on a self-defeating downward spiral of deepening recession and budgetary tightening, in turn sucking out more economic dynamism. Understandably, the debate is particularly intense in Europe, where growth and employment has been particularly lackluster, and which is generally regarded as the epicenter of the current problems.

The Greek election last weekend indirectly put this very question to the voters. Would it be preferable to commit to continued fiscal austerity in an uncertain effort to convince creditors that debt to GDP might eventually stabilize without further restructuring? Or should the main focus be on quickly restoring growth, leaving fiscal rectitude for later? The results suggest that the Greek electorate proved to be just as divided on the issue as European policymakers appear to be.

These issues are difficult to disentangle and in our view are unlikely to be solved by simple one-size-fits-all solutions. We consider it certainly the case that the balance between fiscal consolidation on the one hand and stimulating growth on the other are important in assessing sovereigns' fundamental creditworthiness. However, it is not the role of a credit rating agency such as Standard & Poor's to provide policy advice. Deciding on policy choices is the domain of governments and their advisors; the rating agency's role as a neutral observer is to express its view on the impact of these choices on the sovereigns' creditworthiness. Consequently, we strongly reject the suggestion by some commentators that Standard & Poor's has taken sides in the growth versus austerity debate, with some saying we have 'demanded' more austerity. This groundless assertion assumes that rating agencies have not only the desire, but also the ability, to effectively prescribe policy choices on whole societies. The explicit claim that rating agencies have a budget-cutting bias is easily exposed as baseless by reviewing our published analysis.

8.1. Fiscal Austerity alone is no Solution

A look at the ratings on eurozone sovereigns puts the debate on a factual basis. When Standard & Poor's lowered the rating on nine euro area sovereigns in January 2012, among them the economic heavyweights of France, Spain, and Italy, we clearly stated our opinion that the European policy choices as agreed in the EU summit on December 9, 2011, had focused too narrowly on restrictive fiscal policy, with the fiscal compact as the cornerstone of this approach. Indeed, at the time we stated our belief that "an effective strategy that would buoy confidence and lower the currently elevated borrowing costs for European sovereigns could include, for example, a greater pooling of fiscal resources and obligations as well as enhanced mutual budgetary oversight". We have also stated that we believe that "a reform process based on a pillar of fiscal austerity alone would risk becoming self-defeating, as domestic demand falls in line with consumers' rising concerns about job security and disposable incomes, eroding national tax revenues" (see Standard & Poor's (2012a))[1]. More recently, when we lowered the rating on Spain in April 2012, we stated our view that "front-loaded fiscal austerity in Spain will likely exacerbate the numerous risks to growth over the medium term, highlighting the importance of offsetting stimulus through labor market and structural reforms" (see Standard & Poor's (2012b))[2]. The essence of these statements is quite obviously at odds with the claim that Standard & Poor's is biased towards, or even 'demands', an all-out fiscal austerity drive, without regard to the consequences.

8.2. Policy Choices Influence Creditworthiness

Another source that shows our approach to the subject is our published sovereign ratings' methodology. Apart from a [or should it be 'In addition to a'] willingness to pay, what matters ultimately for a sovereign's creditworthiness is whether a government will be able to service its debt load. A government's ability to achieve sustainable economic growth is an important factor in analyzing this question under our criteria. After all, the public debt-to-GDP ratio is a ratio, and the denominator (nominal GDP) matters as much as the numerator (debt). Our methodology makes this balanced approach clear: indeed, when deriving the rating on a sovereign, we explicitly assign a somewhat higher weight to economic factors than to fiscal ones. This is a long way from single-mindedly 'demanding'

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1 Standard & Poor's (2012a) *Factors behind our Rating Actions on Eurozone Sovereign Governments*, published 13 January 2012.
www.standardandpoors.com/ratings/articles/en/us/?articleType=HTML&assetID=1245327305715

2 2 Standard & Poor's (2012b) *Ratings on Spain lowered to 'BBB+/A-2' on Debt Concerns; Outlook Negative*, published 26 April 2012.
www.standardandpoors.com/ratings/articles/en/us/?articleType=HTML&assetID=1245332680850

more austerity, even if it were to significantly undercut a country's economic prospects.

While Standard & Poor's does not advise on, let alone demand certain policies, we recognize that policy choices do, of course, matter. They also have a bearing on our opinion on the likelihood that a given sovereign will service its debt in a timely manner. And in many cases, the consolidation of public finances may indeed be a key ingredient in safeguarding sovereign creditworthiness. In an optimal world, advanced-economy sovereigns would have entered the global financial crisis with low levels of public debt (which indeed was the case for Ireland and Spain, before they assumed high private sector debts). We recognize, however, that in the world as we experience it, fiscal space is not infinite, particularly for sovereigns with limited monetary flexibility. Governments with lower debt to GDP have more room to maneuver as a simple algebraic matter of the debt-sustainability formula. Experience has shown that they also would have greater credibility in the market. A government that has run countercyclical fiscal policy in good times can enjoy countercyclical fiscal policy in bad times. We have seen that for countries with a structural current account deficit, it is important to raise public sector savings to help restore external equilibrium.

Our recognition of this reality should not be mistaken for policy advice. But even in instances where we consider that fiscal consolidation is an important element contributing to safeguarding creditworthiness, under our criteria we would not change the ratings if there were to be a temporary slippage in the consolidation progress as long as we were to see that a viable and credible strategy is in place to secure sustainable public finances over a longer term.

8.3. Uncomfortable Truths

In short, contrary to views expressed by some market commentators Standard & Poor's has no bias in favor of pro-growth or pro-austerity policies. In line with our published criteria, we look at a large array of factors, including both economic and growth factors as well as fiscal performance factors. The impact of policy choices on sovereign creditworthiness will depend on the economic and institutional circumstances. Therefore, we will continue to analyze the impact of policy choices on a case-by-case basis rather than adopting sweeping and ideological positions in favor of a particular policy orientation.

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