Averting a Euro-Meltdown:
Sharing Global Responsibility

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Introduction

The financial crises that originated in the USA and to an extent in Europe resulted in a sharp fall in international trade across the globe, GDP in the Advanced economies(AEs), and growth in the Emerging Markets and Developing Countries (EMDCs). The quick and coordinated fiscal and monetary policy response that followed helped in promoting a V shaped recovery in DCs (GDP) and EMDCs (growth). This led to widespread complacency and a neglect of medium-long term policy reform issues that were festering unattended for some time or were exposed by the financial crises. These came to a head in Europe and to some extent in USA in 2011, resulting in the Euro-crises that we face today. This note focuses on these problems and possible solution of the Euro-crisis.

Financial Crises[1]

The World economy has resembled a roller coaster ride since the crisis of 2008, with growth projections and risks relating to the Advanced World (US, Euro, UK) changing from quarter to quarter. However, the Macro-economic issues remain the same as they have since the freezing of capital and financial markets in 2008 was reversed in 2009.

There are three broad issues. One is the financial crisis, how it differs from non-financial ones and the implications of this difference for policy actions, in particular the issue of deleveraging. The second issue is the effectiveness of monetary and fiscal policy in the great recession and after, and the appropriate mix of the two during the recovery period. The third is the basic issue of liquidity versus solvency, vis-a-vis problem countries of Europe now called the "Periphery." The political systems of the advanced countries, much like the political systems in developing countries that faced major crisis earlier, have unfortunately been unwilling and/or unable to cope quickly and effectively.

On the financial crisis and its linkage to recession, Rogoff and Reinhart's warnings in their book on the history of crisis, has been largely ignored by the political systems of these countries. It is therefore useful to reiterate the title of the book, "This Time It is Different." Every time the government, their advisors and the parliaments/legislators who must approve these policies, think that it's different from the crisis that affected other countries and other eras. Unfortunately the lessons learned and applied are too limited to have significant positive impact on the outcome.

De-leveraging

One of these fundamental problems is that of "deleveraging." The process of identifying and solving key issues has been delayed too long. I will give three instances. One is the mortgage market. Everybody knew that the market value of many household loans had fallen dramatically below the current market value of loans and was highly unlikely to rise to this level as long as the de-leveraging process remained incomplete. It was essential to deal

[1] Virmani, Arvind, "Real issues vs. Straw men," Policy Paper, June 2011, https://sites.google.com/site/drarvindvirmani/policy-papers.

quickly and effectively with this consequence of the leverage linked real estate-housing bubble, so that normal mortgage market activity could resume from the corrected base. Political gridlock has apparently led to a dragging out of this problem despite several innovative proposals (available in the public domain) to deal with it.

Second is the policy on rescuing banks and other systemically important financial institutions (SIFIs), particularly in Europe. There has been more emphasis on saving the owners and the creditors of the banks and SIFIs, than on saving the institutions, so that they can quickly go back to normal functioning.

Third is the regulatory systems reform of channels through which this excess leveraging took place (for instance the repo market) in the run-up to the crisis. Perhaps because of the multiplicity of institutions involved in thinking about regulatory reforms, the net has been cast too wide. This has the collateral cost of creating regulatory uncertainty. The resistance to reforms from powerful vested interests in the financial sectors of some countries, has distracted from a clear headed focus on the sequencing of reforms to maximize the benefit-cost ratio, in a period of slow economic recovery.

Macro policy: Fiscal vs. Monetary

On fiscal-monetary policy, there are 3 interlinked sub-issues: The effectiveness of monetary policy, the nature of fiscal policy and its credibility, and the appropriate mix of the two in crises and recovery period. The appropriate mix of fiscal and monetary policy depends on the economic environment and the effectiveness of each policy in that context, which may vary during different sub-phases of the crisis and the recovery. Rogoff-Reinhart conclusion that the recovery from a financial crisis could last up to a decade is pertinent.

The first issue is the effectiveness of monetary policy in the USA and Europe. The speed with which rational expectation orthodoxy was replaced, post-Lehman financial market freezing, by a shift to "Quantitative easing" was surprising. This use of traditional old fashioned and passé monetary (money supply) policy was reassuring to those of us who have never believed that the orthodoxy was applicable to countries with partially developed and segmented capital markets. We nevertheless questioned QE3 because of doubts about its domestic effectiveness vis-à-vis the negative international liquidity spill-over effects, expressed among other things in a commodity boom mimicking 2007-2008. Our point has been that the policy does not appear to have been very effective in raising US growth or employment, in which case fiscal policy remains critical.

In the case of fiscal policy too, the issues remain what they were a year ago when the last article IV consultations of the IMF took place with several advanced countries. The appropriate mix of fiscal expenditure, in terms of investment in (public-goods) infrastructure and current consumption through transfers and subsidies. One has continued to argue that the mix should have been much more heavily weighted towards the former from the start and should have progressively increased during the recovery phase. Further, the issue is not of whether to stabilize and bring down the government debt-GDP ratio, but whether to do it through an immediate sharp fiscal squeeze (expenditure reduction and/or tax rate increase) or to *put in place a legal and administrative apparatus that will achieve this result over the medium-long term*. The first may appear to be more credible but this credibility is in my view temporary and will not last, as growth slows as a direct result of the squeeze. On the

contrary fundamental changes in expenditure policy and tax reform that will credibly reduce the debt-GDP ratio over time should be coupled with an expansion in public investment to fill known gaps in infrastructure. This is more likely to lead to recovery of growth momentum and sustained debt reduction over the medium term and be more credible.

Thus we conclude that the excessive emphasis on monetary policy, an ideological focus on immediate fiscal squeeze as against fundamental changes in the budget balance and an overemphasis on transfers vis-à-vis public infrastructure expenditures has delayed the recovery in the US and contributed to the stalling of growth in Europe.

Insolvency and Burden sharing

Finally, the third and most important issue, which is the liquidity versus solvency of European countries with severe fiscal problems. Where one has differed over the last two years from others is in trying to distinguish between those countries that have a solvency problem and those that have liquidity problem. At a secondary level it may also be relevant whether the insolvency resulted from their own previous actions with or without collusion from market participants and/or whether they forced to become insolvent under threat from others after the crises erupted in 2008. We have argued that unless the solvency problem is solved, conventional Breton Woods programs will only postpone the day of reckoning, while making the solution progressively more difficult as market participants shed the burden of their own past mistakes and/or collusion with authorities. At the very least someone will have to bear the extra cost of converting a solvency problem into a liquidity problem. The issue is of sharing costs between the crisis country and partner countries, and the people of the country and market participants. If country governments failed in their fiscal responsibility to their citizens who in turn elected them so did financial markets and market actors who financed their debt before the crisis. If regulatory laxity by country regulatory authorities allowed their banks and financial institutions to mislead savers and investors into parting with their funds, the latter's' greed and mistakes also played a role. Again both parties should and must share the cost. The Latin American experience showed that multilateral loans and programs allowed the investors responsible for these mistakes/errors an opportunity to minimize the cost to themselves (the longer this support the lower the cost to them?).

Structural reform and real wage reductions, though essential in a fixed rate regime, will not restore competitiveness in a time frame that will obviate the need for Euro area financial markets and governments to bear a substantial part of the costs of insolvency!

Unless all three fundamental problems are dealt with, the US and Advanced Europe will continue to have slow growth and slow recovery, perhaps lasting the decade or so that Professors Rogoff and Reinhart have estimated as the average length of the recovery period from a financial crisis.

Fiscal Debt Sustainability[2]

In our 25 years of interaction with multilateral financial institutions on fiscal issues, we have repeatedly made the following points (which remain valid till today): That the simple rule that growth rate must be more than the real interest rate is a good guide to ensuring that debt GDP ratio declines in the long term. Theory does not tell us what level of the debt-GDP ratio is optimal. A number of factors are important for judging whether this level is too high. My sense is that Economic theory often plays second fiddle to Market Fashions. Let me illustrate this with four points that have a bearing on Fiscal sustainability.

That the simple rule that growth rate must be more than the real interest rate is a good guide to ensuring that debt GDP ratio declines over time. The first basic principle of economics is the debt sustainability condition: $g - r - Pd > 0$ (g is the growth rate, r the real interest rate payable on sovereign debt, Pd is the primary deficit). A sovereign's debt is sustainable if the growth rate exceeds the real interest rate paid on the debt by the extent of the Primary surplus. With few exceptions the public discussion of debt sustainability has been carried out without reference to this basic essential data. Unfortunately this is not new: Over the past 25 years we have often seen even highly respected institutions such as the IMF ignore this simple number when it did not fit with their conclusions and recommendations (which therefore inevitably turned out to be wrong).[3]

Market fashion has shifted dramatically away from this measure since an empirical paper estimated" that 60% was the safe level of gross debt to GDP ratio for every country under the sun. Subsequent work concluded that this was the safe level for Developing countries but the safe level for Developed countries was higher (90%?). I am sure that there will many subsequent revisions and refinements to these estimates. I call this a fashion not because these estimates are not useful, but because it has led to herd behavior in which analysts do not even think it worthwhile to produce and present the basic numbers for the sustainability conditions. It would seem to me that we can easily produce this data, not only for the US, Japan and European countries currently under pressure but also other economies with weak fiscal situations and poorer economic data. This will allow us to define the relative fiscal sustainability of different countries more accurately and identify the source of the problem, the better to deal with it.

Net vs. Gross Debt

Economic theory tells us that, the debt that is relevant to the fiscal sustainability issue is the net debt (debt net of assets) not gross debt. This is such a simple and well understood (by private individuals) principle of economics that it is almost embarrassing to raise it in a

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[2] Virmani, Arvind, "Fiscal Sustainability: Economic Theory vs. Market Fashions," Policy Paper, September, 2011, https://sites.google.com/site/drarvindvirmani/policy-papers

[3] As the Indian growth rate exceeded the interest rate paid on government debt by more than the primary deficit, IMF-WB studies in the 1990s and early 2000s invariably projected a rising interest rate and/or a falling interest rate in the future, to justify fiscal action in the present. The actual outcome was more often the opposite.

professional context. Yet public discourse over the last two years barely ever mentions the asset side of the balance sheet or presents the comparative net debt position of countries under stress. When financial markets sense a crisis, even a minor temporary one, only the short term matters, as each market participant tries to be the first to unload its holding of the concerned sovereign debt or loans. Only the gross debt, coming due and needing refinancing seems to matter to the markets. If this is true, why call it a 'market fashion'? Because it is the obligation and duty of responsible analysts, including the international financial institutions, to focus not just on the short term but also on the medium and long term – the original definition of "sustainability". The short term can be dealt with by liquidity support, whether from the Country's Central Bank or the IMF, it is or should be the medium term that determines sustainability.

The theorists who emphasize Net debt are quite aware of the problem of maturity mismatch between sovereign debt and sovereign assets (e.g. loans or bond debt and public companies or infrastructure assets) and about the difference in risk associated with the different type of assets (e.g. physical assets versus future tax obligations). This cannot distract from the basic economic fact that fiscal solvency depends on the net debt position – a country or individual cannot be insolvent if its assets exceed its debt. Further, the fact that a country's fiscal situation (as against an individual's) can be sustainable with debt larger than its assets matters even in the short term, because it is possible to loan or sell some assets (perhaps at a discount) to meet short term debt obligations! The safety threshold of 60% or 90% gross Debt-GDP ratio will surely be refined if we put in the effort to determine net debt. To say that we do not have a perfect measure of sovereign assets or net debt is an evasion; imperfect measures (for instance physical assets valued at depreciated book value) are better than no measures, if we are clear and transparent about the limitations.

Net External Assets/Debt

The theory also makes a distinction between sovereign debt financed externally and that financed domestically, though mostly in a very elementary manner of differential interest rates. Some of us who have had to advise on fiscal control and fiscal debt issues and to face the consequences of bad or incomplete advice, have long asserted that external financing of sovereign debt is not worth the risk. The advantage of lower nominal interest is very tempting economically and politically: However the exchange risk is likely to be neglected or ignored and the danger of sudden stops and reversals is very real. The country can suddenly find itself at huge risk from shocks to global financial markets and overreaction to temporary problems in the domestic economy and polity. In addition the valuation of assets that go into the determination of net debt, is likely to be asymmetric – foreign lenders to the sovereign are likely to value it much less than domestic debt holders relative to debt. Besides the home bias and exchange risk, other factors include differential costs of using the legal system.

Recent, preliminary empirical analysis also suggests that the net external debt of a country has a positive effect on the volatility of capital flows (i.e. higher net debt more capital flow volatility). In other words the lower the cumulative gap between domestic investment and domestic saving (Id-Sd) the more stable capital flows are likely to be. This implies that higher domestic private and household savings are likely to lead to lower capital volatility lower risk to foreign borrowing (private and government) and a higher threshold

limit for safe Debt-GDP ratios. The hypothesis is that (other things being equal), higher domestic private saving rates allow a country to sustain higher Sovereign Debt-GDP levels.[1] If this is true it would certainly be useful to know the relative household and private saving rates of different countries, along with the other data mentioned above. We would then be in a better position to judge relative fiscal sustainability and to identify the key problems and focus on the policies that can make a difference.

Aggregate Demand

The demand conditions in the economy relative to potential supply. An economy suffering from lack of effective demand (virtually all advanced economies today), need to balance policy measure to ensure medium-long run debt reduction, with investment in public and quasi public goods in the short run to ensure effective demand. If this is not done, growth will suffer and debt-GDP ratios will end up higher than they could be! However, in economies suffering from excess demand (several Emerging economies today) and inflation, immediate fiscal (expenditure) contraction can allow a more relaxed monetary policy that will sustain growth and accelerate debt reduction.

The Basic problem of Euro Debt [4]

Many imaginative, perhaps, even innovative approaches are being proposed for dealing with Euro crises. They contain a wealth of interesting ideas and mechanisms that can be useful in designing solutions. There is a danger however, of getting lost in the minutiae of solutions and forgetting the basic fundamental economic problem that has to be addressed.
One of the most important lessons of the financial bubble and the subsequent financial crisis in the USA was that the slicing, dicing and recombining risk through levels and layers does not necessarily help risk diversification; it can as likely help to hide risk from innocent buyers of these products and make it easier to fool them into thinking that the risk has somehow dis-appeared. In other words, the finest financial engineering cannot make the existing risk magically vanish, it can only hide it and confuse the naïve for a while. Even the latter will be short lived as long as the memory of the financial crisis remains in the public mind! It is therefore useful to go back to the source(s) of the Euro crises and reiterate the essential economic measures that are required to diffuse the crisis!

There are five elements of any viable solution:-

(1) *Sustainability*
Countries with unsustainable debt must put it on a sustainable path through a combination of fundamental reform of the expenditure, tax, transfer and growth policies. The objective is to meet the sovereign debt sustainability condition.[5] In this context it is important to remember

[4] Virmani, Arvind, "Dealing with the Basic Problem of Euro debt instead of Financial Engineering", October 27, 2011. http://dravirmani.blogspot.com/2011_10_01_archive.html

[5] g-r+Pb > 0, where g = GDP growth rate, r = real interest rate on sovereign debt, Pb = Primary balance.

that a fiscal squeeze by previously extravagant countries is not a morality play but an attempt to meet the debt sustainability condition! Thus, beyond some point (the optimal) an immediate and sharp fiscal squeeze will reduce growth more than it increases the primary balance or reduces the real interest rate and thus make the fiscal situation less (not more) viable. Policy reforms to accelerate economic growth in a sustained manner are the key to long term sustainability. All else is merely an exercise in providing breathing space!

(2) Debt Restructuring

Greece (+Portugal?) is in a situation in which even the optimal policy mix outlined in (1) cannot put it in a sustainable path without debt restructuring. In other words, Greece has been structurally insolvent for the past year or so. The 'grant' funds needed to convert this problem from one of insolvency to one of liquidity must come from somewhere outside Greece - no amount of financial engineering can make this fact disappear. Rough calculations suggest that a 60% haircut on Greek government debt would be sufficient to make Greece solvent. It seems logical and fair that those who took the risk (or deliberately overlooked it) to earn higher returns (profits, bonuses) from Greece should pay when the risk materializes.

(3) Bank Recapitalization

A Greek debt restructuring will have consequences for Euro area banks who have lent to Greece. These consequences should have been anticipated and dealt with at least a year ago, by recapitalizing the banks. The European Banking Authority now (reportedly) estimates these cost to be of the order of Euro 80 -100 bi (FT Oct. 20, 2011). To the extent that private investors are unwilling to raise the equity in these banks, the home country of these banks will have to provide the capital. The 60% haircut on Greek debt presumably accounts for the indirect cost to the Greek Govt. of the effect of this default on Greek banks. Other affected countries would also have to do the needful. To the extent that the home country is not in a position to recapitalize, support is needed from outside the home country- the EFSF can be used to provide this additional support, either for direct financing or to underwrite repayments. If the above estimate is correct, there will be money left over in the EFSF to strengthen the provisioning of bank loans to governments of countries that are on the border line of solvency, so as to remove doubts about potential contagion to these countries.

(4) *European Central Bank*

Once the direct and indirect effects of solvency problem (of Greece and Portugal) are addressed, the borderline Euro area countries, such as Spain and Italy, would be left with a liquidity problem. If the ECB acted like a normal country central bank, such as the US FED, it could provide as much liquidity as needed to solve the liquidity problems of Spain and Italy. As there is no explicit medium-long term grant element (once steps 1-3 are undertaken), there is no economic reason for not doing so in a period of low demand and low inflation (only ideology or primordial fear). To the extent that mark to market accounting will impose temporary balance sheet losses on the ECB, the EFSF/ESM could be used to provide fiscal support till the markets stabilize and return to normal (at which point the 'mark to market' profits of ECB would revert to the EFSF/ESM).

A simple example illustrates. Assume that the long term interest rate for a solvent Italy is the German rate +0.5%. Because of all the problems outlined above, the premium above

Germany has gone up to 4.5% (say). Thus the ECB will be effectively picking up the risk equivalent to 4% points for debt coming due in the next 6 -12 months and will therefore constitute 'mark to market losses' in its balance sheet of this amount. This fiscal cost has to be borne by the EFCF till the markets are persuaded that the problems at 1-3 have been credibly addressed (after which Italian interest rate will go back to the German rate +0.5%). Thus the fiscal cost is borne by the EFCF/ESM not the ECB – with Euro 300 billion of Italian debt coming due in the next 12 months (in this example) the temporary fiscal cost to be borne by the EFSF will be Euro 12 bi). The ECB must provide the liquidity, whether directly or through Commercial Banks or through National Banks.

Implementation of this point apparently requires a change in the ECB constitution to allow it to do so (in parallel with changes to impose tough fiscal rules on Euro-countries). This may however take too long to stave of a crisis in the next 12 months. One possibility that has been suggested is the issue of Euro Bonds. However, it is unclear whether this has any greater feasibility till the fiscal rules have been changed by treaty. There is however, an alternative that may be worth considering.

National Banks within the Euro area, such as the German Bundesbank still exist, but do not have the authority to undertake monetary policy (interest rates) or to create money (Euros). This authority has been ceded to the European Central Bank (ECB). They do, however, still have the capacity to issue euro bonds to raise hard cash and their debts are still implicitly or explicitly guaranteed by their National governments. Thus these would have triple A rating in countries with a similar rating. To the best of my knowledge, there is nothing barring the ECB from buying such bonds as part of any effort to increase liquidity in the Euro zone. The money raised in this way could in turn be used by the National Banks to create a special bilateral funding arrangement in the IMF. Given the preferred creditor status of the IMF, this would preserve the triple A chain. The funds could then be used to provide liquidity support to fundamentally solvent (even if currently stressed) Euro governments, under a fund program that ensures that these governments undertake the policy reforms that ensure debt sustainability (point 1 of Oct 27 blog). Non-Euro area countries with a current account and trade surplus, such as China could also contribute to the bilateral fund in the IMF if they choose to do so.

(5) *International Monetary Fund*

Finally for other non-Euro area countries that may be affected in the days/weeks/months following a Greek debt restructuring, the IMF must stand ready to provide liquidity support to "innocent bystanders". The IMF still has sufficient funds for this purpose, and these could easily be augmented to the needed extent, if prior action has been taken on points 1 to 4 above.

The longer the basic problems outlined above remain unaddressed, the more difficult they become to address, as private creditors gradually reduce their exposure to insolvent countries at the cost of official and multilateral lenders and borderline solvent countries are pushed over the line by rising interest rates.

The IMF, given its expertise in enforcing fiscal and monetary discipline for restoring Balance of payment sustainability, has already been involved in helping the Euro-area governments enforce policy reforms (conditionality) on Greece and Portugal for the support they are receiving from the Euro area (2/3rd) and the IMF (1/3rd). This has however

involved the IMF providing unprecedented level of funds (100s and 1000s of times their normal entitlement) and extraordinary fiscal support to sovereigns that markets consider insolvent. In principle the genuine and valuable role of the IMF in enforcing conditionality on delinquent sovereigns can be provided with much lower levels of financial support, as was done historically in Latin America, Asia and other continents!

(6) Rest of the World

From a global perspective the question is, what should the Rest of the World do to ensure that the Euro crisis is contained and any potential contagion to countries outside the Euro area minimized? To answer this question it is essential to recognize that the World is currently suffering from a severe shortage of effective demand. Thus there are two types of countries which are playing or should play different roles in diffusing the global crisis. On one side are the current account and trade (goods and services) deficit countries who are making a net contribution to the global demand from the rest of the world, including the countries in crises. Without their continuing contribution there, it is impossible for the crises and near crises countries to reduce or eliminate their current account deficits in the next few years.

On the other side is the current account and trade (G&S) surplus countries, which are earning foreign income and accumulating foreign assets/ reserves. These countries have the international resources to reallocate their foreign earnings/assets into alternative channels, including to international financial institutions, to build a loan fund/buffer for ensuring that "innocent bystanders" hit by contagion from any euro-crises are provided adequate liquidity support. It is their obligation and duty to do so as long as they remain in surplus. One way of doing this is to contribute to a bilateral loan fund in the IMF. This would be fair and evenhanded contribution by all non-euro countries to help save the rest of the World from the negative contagion effects of the Euro crises and a potential melt-down of the Euro. To the extent that some of these contributors are middle income countries, it would be legitimate to ask non-contributing rich countries to underwrite part of the risk. The precise nature of the contribution and the manner in which it should be used, would need to be worked out in co-operation with the potential donors to this fund.

In between these two types of countries, are an ambiguous type, which can contribute either through an increase in their net purchase of goods and services from the rest of the World or through bilateral provision of funds to IFIs/IMF or a combination of the two, depending on their income levels and reserve currency standing.

Another source of funds for providing global liquidity could be fresh SDR allocations. The conversion of SDRs into hard currencies by those in need of liquidity would have to be carefully circumscribed as long as the Euro crisis lasts. This is because a Euro-meltdown will result in a credit squeeze by European banks that is likely to lead to a sudden stop/capial outflow from emerging market economies. Thus emerging economies with Current account and trade deficits which are dependent on foreign capital will become vulnerable even if they have substantial foreign exchange reserves. Minimization of contagion thus requires that these countries be shielded from demands for SDR conversions into free foreign exchange. Any substantial new issue of SDRs should ensure this risk mitigation feature!

Conclusion

The Euro area countries have because of political constraints, spent almost two years tiptoeing around the Greek crisis because of the fear of contagion to Italy, Spain and other countries. In the meanwhile, contagion has inevitably reached these two countries. Thus there was no escape from finally addressing the real problems and crafting basic solutions. Though there has been movement in this direction in the last 3 months, one critical element remains unaddressed. This is the inescapable fact that, unless the ECB acts (however indirectly) as a lender of last resort by providing unlimited liquidity to countries whose governments are solvent, the Democles sword of a Euro meltdown will continue to hang over the Global economy.

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