

Ahrens, Steffen et al.

**Conference Paper**

## Fighting sovereign debt crises worldwide

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## The Global Economy

# Fighting Sovereign Debt Crises Worldwide

### The Challenges

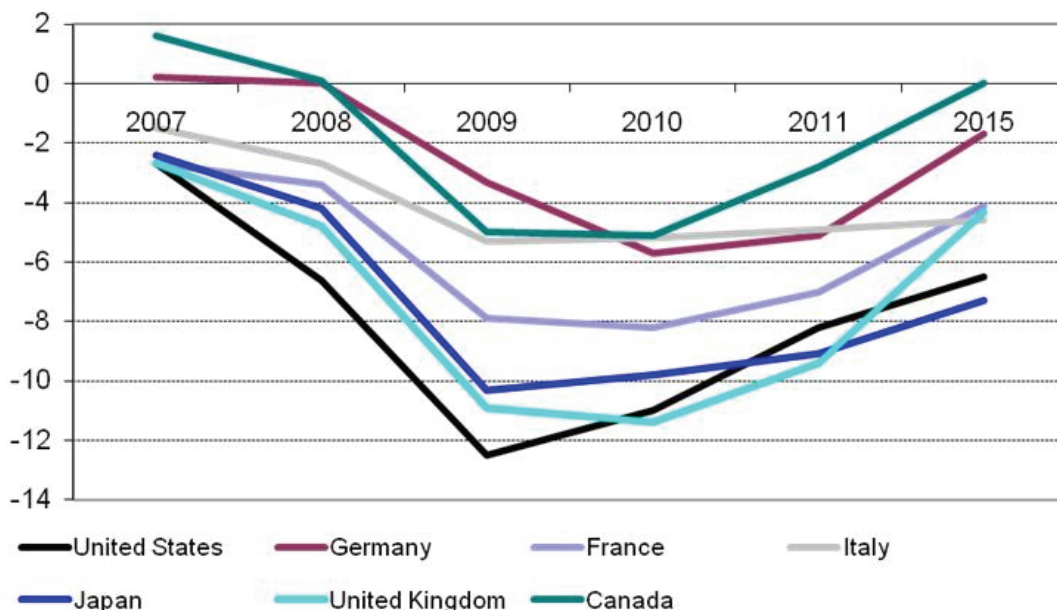
In dealing with the past financial crisis, have we sown the seeds for a national debt crisis? The massive increase in public debt that has resulted from the crisis is of particular concern. This rise of public debt has made it more difficult to use expansionary fiscal policies to fight the next crisis.



Public debt is rising particularly fast in countries with ageing populations, threatening public confidence in the sustainability of their social security systems. It is conceivable that high public debt and a resulting downgrading of public bonds could in itself trigger a new crisis. Unless economic growth re-emerges faster than consensus projections, rising sovereign debts will likely present a serious problem in many countries.

What are the appropriate fiscal exit strategies from the recent global economic crisis? What are the consequences of these crises on the global economic development? Is there a global strategy and what are its national impacts? How should the burden of fiscal consolidation be shared across social groups? How can governments strike the right balance between macroeconomic management and debt sustainability? How can government ensure that their debt burden does not rise faster than national product over the business cycle? Should the governments' implicit assets and liabilities be counted along with the explicit ones in assessing the national debt burden? What fiscal strategies could ensure that governments are able to provide adequate fiscal stimulus in times of recession, while maintaining long-term fiscal rectitude?

**Major Advanced Economies: General Government Fiscal Balances (Net Lending or Borrowing in Percent of GDP)**



Source: International Monetary Fund, World Economic Outlook, April 2010, page 169.





## **Proposed Solutions**

### **Steffen Ahrens**

*Kiel Institute for the World Economy*

### **Andreas Esche**

*Head of the Demographic Change Campaign Project, Bertelsmann Stiftung*

### **Harmen Lehment**

*Kiel Institute for the World Economy*

1. Exit from current expansionary macroeconomic policies should give priority to fiscal consolidation. Fiscal restriction should be combined with prolonged monetary easing to keep aggregate demand on a path that supports an economic upswing at low inflation rates.
2. To provide a guideline for the fiscal consolidation path, independent institutions should provide estimates of the degree of fiscal restriction that would permit the central bank to leave interest rates unchanged. Actual fiscal restriction should be close to, but not go beyond this benchmark.
3. Consolidation paths within monetary unions, in particular the EMU, should as a rule be translated into national consolidation paths on the basis of a percentage reduction of the initial structural budget deficits. This implies that countries with relatively high structural deficits have to pursue more pronounced consolidation policies than countries with low structural deficits.
4. Fiscal consolidation should be continued until the debt-GDP ratio has reached a sustainable level. Calculations of sustainable levels should account for the governments' implicit assets and liabilities.
5. Constitutional barriers against excessive deficit financing should be strengthened. Deviations from the consolidation path should be restricted to cases of major macro-economic imbalances. The decision of whether and to which extent a deviation from the consolidation path is justified should not be in the discretion of the respective government, but should be delegated to an independent debt commission. Stronger barriers against deviations from the consolidating path would also provide a shelter against destabilizing speculation as in the case of Greece.
6. Reductions in public expenditures are an important cornerstone of budget consolidations. The findings of international studies indicate that consolidations with a stronger emphasis on the expenditure side are more sustainable in the medium term. On the other hand, increasing revenues also contribute to budget consolidation. Thus, successful budget consolidations are composed of measures on the expenditure side as well as on the revenue side.
7. In addition to expenditure-based and revenue-based measures, successful budget consolidations need institutional reforms. Examples for such reforms are: strengthening of the position of the Minister of Finance and of the top-down approach in budgeting processes, budgets with a two-year horizon (or even longer), binding commitments on precise consolidation targets at the beginning of a legislative period within the framework of coalition agreements or government declarations (targets concerning the reduction of the annual deficits or the reduction of public debts), constitutional changes in order to strengthen budget discipline such as the Swiss Debt Brake obligation to submit a financing proposal for every additional expenditure request.



8. Due to the demographic change within the coming decades, it is necessary to strengthen the basis of growth and productivity. As such, consolidation should not take place at the costs of investments for the future such as education and health.

### **Hans-Paul Bürkner**

*President and CEO, The Boston Consulting Group*

- Providing transparency on the balance sheet and off balance sheet items.
- Increasing capital requirements significantly.
- Incorporating all financial institutions into regulatory framework.

### **Daniel Gros**

*Director, The Centre for European Policy Studies*

### **Create a European Monetary Fund**

Now is the time to set up a European Monetary Fund (EMF) to provide a framework for liquidity or insolvency crisis in the euro area. The existing €860 billion facilities for Greece and the euro stabilization mechanism should be merged into the EMF. Experience has by now shown that without a clear framework, decisions about how to organize financial support typically have to be taken hurriedly, under extreme time pressure, and often during a weekend when the turmoil in financial markets has become unbearable, making a full bailout the only option. The existing European Financial Stability Facility is to be used only in an emergency and it represents “funding without a fund,” i.e., it lacks a clear permanent framework. The EMF would have key advantages:

- First, the funding of the EMF should give clear incentives for countries to keep their fiscal house in order at all times.
- Secondly, and perhaps even more important, the EMF could provide for an orderly sovereign bankruptcy procedure that minimizes the disruption resulting from a default.

Recent events have vividly demonstrated that in the absence of a mechanism to manage an orderly sovereign default, adjustment programs lack credibility and the balance sheet of the ECB is put at risk. Indeed, without a fiscal agent like the EMF in times of crises, the ECB becomes the fiscal agent of euro area governments by default. This role, if maintained, will destroy the institution in the long run.

Both the incentives for fiscal discipline and the establishment of bankruptcy procedures for euro sovereigns would decisively lower the moral hazard problem that pervades the present situation in which both the markets and the government of the country under pressure assume that, in the end, they can count on a bailout because the EU could not contemplate the bankruptcy of one of its members. We should by now have learned that policy should not only be geared towards preventing failure, but preparing for it. In addition, the EMF could contribute decisively to the transparency of public finances because its intervention mechanism in the case of failure would penalize all derivatives and other transactions that had not been previously registered with a special registry of public debt, which the EMF would maintain.

The issue of how to deal with a sovereign default in Europe should not longer be avoided under the premise that what is not desirable will not happen.



## **Dennis J. Snower**

*Director, GES; President, Kiel Institute for the World Economy*

***Governments should avoid sovereign debt crises by (i) formulating a fiscal rule and (ii) establishing an international debt commission to implement it. This commission should be given the final say over public deficits and surpluses.***

Fiscal policy must be reformed to satisfy the following prerequisites: (a) The national debt ratio (ratio of national debt to national product) must remain stable over the long run. (b) Governments must be able to fight large recessions with large fiscal expansions, extending beyond the automatic stabilizers of the tax and benefit systems. (c) Governments must be required to give up their sovereignty over fiscal policy as prerequisite for receiving international assistance during debt crises.

Under the current international arrangements, prerequisite (a) may be violated (since the debt ratios of many advanced countries have exploded in the aftermath of the last financial crisis), prerequisite (b) may be violated in the process of bringing exploding national debt under control, and prerequisite (c) may be violated by outside conditions imposed on heavily indebted countries (such as conditions by the IMF or the EU Commission).

The following two-step fiscal proposal would meet these three prerequisites.

Step I: First, every government that seeks to qualify for rescue packages, in case of national debt crisis, should formulate a fiscal rule that specifies three features: (1) the long-term debt ratio, (2) how fast this ratio is to be approached and (3) how countercyclical its fiscal policy is to be.

Step II: The government should establish an independent debt commission for its country to estimate the country's position in the business cycle and, on this basis, implement the fiscal rule by determining the government deficit or surplus. This debt commission must have the final say over deficits and surpluses, much as the central bank has the final say over monetary policy.

Under this system, countries like Greece could now fight its recession through deficit spending without raising the interest rate on its government bonds, because financial markets would be assured that in the longer run its debt ratio will be brought under control. The EU could provide generous loans and guarantees for such countries, since their debt commissions would guarantee that their debts will be repaid.

## **Uwe Wagschal**

*Professor for Comparative Government, Albert-Ludwigs-Universität Freiburg*

### **Guidelines and recommendations for successful budget consolidations**

The following proposed lessons and solutions are mainly based on empirical findings for the OECD countries. They are separated for five specific fields of action, i.e., the budget and its composition, budget institutions and procedures, new rules, politics and soft factors. The economic crisis of 2008 and 2009 strongly affected consolidation efforts. This fits with the long-run empirical findings which identified socio-economic factors like economic growth as the most important determinants of budget consolidations. However, other institutional and political factors matter also.



## **1. The budget and its composition**

1. Cutting down expenditures is much more successful than increasing revenues. However, in the political process it might be appropriate to increase taxes, since it makes the political communication of a consolidation easier. Several countries have introduced special taxes especially for consolidation purposes.
2. There are significant differences in the composition of expenditure between consolidators and non-consolidators. An analysis of the COFOG (Classification of Function of Government) data revealed significant expenditure cuts for nearly all countries in the areas of general public services, economic affairs (notably subsidies, slightly less investment) and defense. Huge differences in the expenditure profile can be observed especially for social security and health expenditures. The consolidators in the OECD have been more restrictive on these items.
3. Governments should stop the automatic increase of social expenditures. Several countries like Sweden, Belgium or Italy stopped indexing or changed the adaption formula. Demographic factors for a fair inter-generational burden share of consolidation should be introduced.

## **2. Budget institutions and procedures**

4. Governments should make their budget forecasts “fail-safe.” Some countries made discounts for their macroeconomic assumptions, giving them more leeway during the crisis.
5. In the consolidation process it is important whether a country follows a so-called “delegations” or a “commitment” approach. Typically, majority systems concentrate more on the delegations approach—which includes a strengthening of the position of the minister of finance—than countries that are organized on the basis of a consensus democracy. Some successful consolidators substantially reformed their budget institutions. Especially countries like Canada and Italy strengthened the “delegations institutions,” while Belgium and the Netherlands went for a commitment strategy and some countries like Sweden chose a mixed strategy.
6. Benchmarking has proven to be a successful instrument for assessing government expenditures in comparative perspective.
7. The data on public debt is usually not correct. Long-term financial liabilities of states, e.g., for public pensions for which there are no provisions, should be included. A reliable measurement of this data has to be implemented. The need for consolidation is therefore much higher.

## **3. New rules**

8. Unexpected surpluses and so-called “windfall profits” have to be used entirely for public debt reductions.
9. Salary increases for politicians and public employees as well as increases of social transfers should only be allowed when the budget is close to balance.
10. In the past, fiscal and constitutional rules have not always been effective in preventing debt accumulation. The international comparison and experiences give indications that both the Swiss debt brake and expenditure rules are rather successful instruments.
11. In accordance with a top-down strategy the finance minister should have a veto to block public spending.



12. International transfers either in the European Union or in international assistance should be conditioned. Social standards in the recipient countries (e.g., retirement age) have to be adjusted to the level of the donor countries.

#### **4. Politics**

13. Empirically, there are no differences in the consolidation success of left-wing and right-wing governments or of single-party governments and minority governments. First and foremost, the decision-makers' political will for a long and successful consolidation process is vital.
14. Any policy that involves expenditure cuts or tax increases will be unpopular. In order to reduce the risk of subsequently being punished by the electorate, governments might follow a strategy of "blame avoidance" or "blame-shifting."
15. It is important to aim at a fair distribution of the consolidation burden. Undoubtedly there will be some net losers as a result of cuts in spending. However, the example of New Zealand showed that an equal and fair distribution of the negative effects across all socially relevant groups leads to a high level of reform acceptance. In many countries, the linking of consolidation processes to the effort of maintaining the welfare state has proved to be a recipe for success.

#### **5. Soft factors**

16. Governments are well advised to make use of the "honeymoon effect": Consolidations have a good chance of success if they are carried out soon after a substantial change in the party composition of a government. In this case the consolidation episode is also longer.
17. In many countries, successful consolidations are connected to specific politicians and their leadership qualities. Usually, these consolidators are either heads of government or ministers of finance, as names like Göran Persson, Paavo Liponen, Wim Kok, Margaret Thatcher, Roger Douglas or Paul Martin have become synonymous with consolidation successes. However, this outstanding degree of political "will" and "skill" is difficult to promote.