Abstracts / Résumés

The *Financial Stability Review* No. 16 selected the issue of Public Debt. The unprecedented level of public debt in advanced economies is the most pressing and difficult issue that they are confronting with. The purpose of the review is to investigate the various aspects of public debt and the challenges it poses to policy makers. Once again, the Banque de France invited various viewpoints to be expressed on this very topical issue and we are delighted to present this variety of views.

For pedagogical purposes, the current issue is divided into four parts :
I) macro-economic, fiscal and operational context;
II) financial and regulatory aspects;
III) monetary policy focus;
IV) regional and international dimensions.

The abstracts of the various articles can be found below in the following pages.

Introduction

Central banking in a context of high public debt

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Against the backdrop of the financial crisis and unprecedented high public debt, the demands placed on all the major central banks have grown tremendously over recent years. They have responded by taking non-standard measures, adjusting their operational frameworks and significantly expanding their balance sheets.

We may have to live with this conjunction of high debt and non-standard monetary measures for some time to come. It is, therefore, essential to maintain clarity of purpose and protect the two core pillars of central banking, inherited from the pre-crisis consensus: the focus on price stability and, its corollary, central bank independence.

MACRO-FISCAL AND OPERATIONAL CONTEXT

Fiscal outlook and fiscal sustainability risks

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The paper assesses the outlook for public finances in both advanced and emerging economies following the financial crisis. It highlights the risks arising from the current outlook and discusses the key reasons for different market responses to the deterioration of the fiscal accounts across the regions of the world (e.g. between Europe on one side and the United States and Japan on the other side). It draws policy implications for the short and medium term.

When Western sovereign risk is in play

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Sovereign risk was a big macro theme in 2011, and understandably so. This theme will not abate in 2012. Indeed, this year will likely feature many additional sovereign risk developments that will impact in a consequential manner the functioning of the global economy and financial markets. In the process, they will continue to fuel uncertainty and volatility, to alter the behaviour of companies and individuals, to challenge the effectiveness of government policies, and to impact market correlations and stability. Both the public and private sector need to understand better the dynamics of Western sovereign risk and, importantly, react responsively and in a more timely, comprehensive and decisive manner. They need to pivot from a reactionary mode to a pre-emptive one. And they need to do so in a coordinated and sustained fashion otherwise they will all find it much harder to restore growth, jobs and financial stability.

The return of financial repression

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Periods of high indebtedness have historically been associated with a rising incidence of default or restructuring of public and private debts. Sometimes the debt restructuring is more subtle and takes the form of "*financial repression*". Consistent negative real interest rates are equivalent to a tax on bond holders and, more generally, savers. In the heavily regulated financial markets of the Bretton Woods system, a variety of financial domestic and international restrictions facilitated a sharp and rapid reduction or "*liquidation*" of public debt from the late 1940s to the 1970s. The restrictions or regulatory measures of that era had their origins in what would now come under the heading of "macroprudential" concerns in the wake of the severe banking crises that swept many countries in the early 1930s. The surge in public debts that followed during the Great Depression and through World War II only made the case for stable and low interest rates and directed credit more compelling to policymakers. The resurgence of financial repression in the wake of the 2007-2009 financial crises alongside the surge in public debts in advanced economies is documented here. This process of financial "de-globalisation" may have only just begun.

FINANCIAL AND REGULATORY ASPECTS

A tale of two overhangs: the nexus of financial sector and sovereign credit risks

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There has emerged in the Western economies a strong nexus between the credit risks of financial sectors and their sovereigns. We argue that this phenomenon can be understood in the context of two debt overhang problems: one affecting the financial sector due to its under-capitalisation following the crisis of 2007-08; the second, affecting the non-financial sector, whose incentives are crowded out by high sovereign debt and anticipated future taxes. While the desire to resolve the financial sector overhang may make bailouts tempting, they raise the risk of exacerbating the overhang related to sovereign debt. Conversely, reduction of growth prospects due to sovereign debt overhang can make the financial sector riskier as it is highly exposed to sovereign debt both through direct holdings and indirectly through implicit government guarantees. We provide evidence on this important nexus, based on our ongoing research that exploits data on European bank and sovereign credit risks.

Banks, moral hazard, and public debts

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In financial crises, private debts typically turn into public debt. In the case of private bank debt, a risk is that sovereign debt may balloon out of control because of actions taken to prevent the collapse of banking systems.

This paper discusses some issues related to this interaction between bank debt and sovereign debt. Specifically, it recalls well-identified stylised facts about the loop between banks and sovereigns. It suggests that, beyond positive reasons, some normative considerations explain the nature and intensity of this loop. From a policy perspective, it assesses the implications of some recent developments in regulation and public policies, points out what could be done to reduce the chances of a negative bank-sovereign feedback loop, and evaluates whether the options to better allocate the costs of crises are mutually consistent.

Clearly, the crisis requires a fundamental rethink of previously commonly accepted views. One was that risky private debt could easily be morphed into high quality and liquid assets. Another was there are intrinsically riskless financial assets. Efforts by policy-makers are underway to create a new normal, where all risks are properly measured and understood, are fully priced in and their quantity better controlled. Moving to a new normal also requires that fiscal rules and discipline are better entrenched through robust and time consistent policy frameworks.

Sovereign creditworthiness and financial stability: an international perspective

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Financial stability depends critically on the two-way interaction between banks and governments. Sovereign creditworthiness represents the ultimate source of insurance for the financial system and provides a solid basis for the pricing of assets, by supplying a risk-free security. A sound banking sector ensures the smooth flow of credit to the economy as well as solid revenue and financing for the government. Weakness in either sector can give rise to a vicious circle of uncertainty and distress with highly damaging consequences for the economy. An interconnected global economy means that problems can propagate across borders. The policy recommendation is simple: appropriate buffers should be built in good times to cushion the impact of bad times. Fiscal buffers support the risk-free status of sovereign debt, while capital and liquidity buffers underpin the soundness of the financial system.

Stability, growth and regulatory reform

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An enormous effort has gone into banking and financial regulatory reform following the recent financial crisis. The paper is an attempt to describe some key open questions about the relation among stability, growth, and regulatory reform and then raise some concerns about overemphasis on some instruments and underemphasis on others in the ongoing reform process.

Is sovereign risk properly addressed by financial regulation?

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The treatment of sovereign risk in banking and insurance regulations has been highlighted by the sovereign debt strains affecting most advanced economies. In particular, it has become key to assess whether these regulations require from financial institutions to hold adequate regulatory capital associated with sovereign exposures. More broadly, although the main issue raised by the sovereign debt crisis is related to fiscal policies and consolidation, one crucial question is to determine how and to what extent financial regulation can help to mitigate and prevent vulnerabilities of the financial sector to sovereign risk. From this perspective, it appears that current regulatory framework does not require from financial institutions to hold significant regulatory capital against sovereign risk, inadequately assuming sovereign debt as a low-risk and even a risk-free asset class. Furthermore, some regulatory initiatives, while globally enhancing standards, could create further incentives to encourage financial institutions to hold sovereign debt. In addition to considering better reflection of sovereign risk in financial regulation, supervisory practices also appear as a crucial tool to address the issue of heightened sovereign risk and its potential impact on financial stability.

MONETARY POLICY FOCUS

Contagion and the European debt crisis

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The financial and economic crisis that started in August 2007 is a clear case of the materialisation and propagation of systemic risk. The banking crisis reached a climax in September 2008 with the demise of Lehman Brothers and the subsequent support to the financial system. In spring 2010, it turned into a sovereign debt crisis. Widespread instabilities repeatedly reached new heights since the summer of 2011. This article addresses a phenomenon which is at the very centre of what we are experiencing in the euro area, the phenomenon of contagion. Contagion is one of the mechanisms by which financial instability becomes so widespread that a crisis reaches systemic dimensions. The article argues that contagion phenomena play a crucial role in exacerbating the sovereign debt problems in the euro area. As a consequence, crisis management by all competent authorities should focus on the policy measures that are able to contain and mitigate contagion. Several of the European Central Bank's interventions have been motivated by the need to address contagion.

Monetary policy and public debt

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When the public sector of a country becomes so indebted that its fiscal sustainability is potentially at risk, then monetary policy has to be, perforce, closely integrated with debt management and fiscal policy. This was the case in the United Kingdom in the decades after World War II. By the 1980s, however, debt ratios had fallen and fiscal policies were sufficiently controlled to allow for a separation principle to be adopted whereby each policy mechanism, i.e. setting interest rates, debt management, fiscal (budgetary) policy were separately and independently run according to their own set of individual objectives. As fiscal policies have recently been compromised, and debt ratios become much enlarged, that separation principle is becoming subject to increasing stress. We are reverting to the more complex conditions which faced the Bank of England after each of the World Wars.

Does monetary cooperation or confrontation lead to successful fiscal consolidation?

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Accommodation of fiscal authorities by monetary policy is controversial, as can be seen in current euro area discussions. Some go further and suggest that confrontational enforcement by central banks taking a hard line on adjustment is critical to inducing longer-term fiscal stabilisation. Others suggest that fiscal commitment must come first. This article steps back to look at the historical record of central bank behaviour vis-à-vis fiscal authorities, at least until the current crisis period, and whether cooperative approaches ahead of consolidations have proven as dangerous as some would suggest.

Fiscal challenges to monetary dominance in the euro area: a theoretical perspective

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The government debt and banking turmoil that persists in several euro area countries begs the question of why countries such as the United States or Japan, which do not have less debt, have not been affected by the same problems. To shed light on this question, two forms of monetary dominance should be distinguished. According to the first (soft, or preventive) form of monetary dominance, the government adjusts its fiscal policy so as to avoid having to choose between a default or debt monetisation. In the second case (hard form of monetary dominance), in the extreme situation where this choice has to be made, the monetary authorities let the government default rather than monetising the debt. We show that hard monetary dominance may reduce the probability of fiscal adjustment and, if it is not perfectly credible, may increase the probability of inflation.

Central bank independence and sovereign default

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This article relaxes the assumption usually assumed in the existing literature that the fiscal authority will never default on obligations issued on its own currency. It shows that a sufficiently tough central bank does have the ability to control the price level, regardless of the behaviour of the fiscal authority. In order to achieve independent control of the price level where the debt of the fiscal authority is defaultable, the central bank should be willing to allow the fiscal authority to default on its debt. However such a commitment to letting the fiscal authority default may expose the country to risks of short-term and medium-term output losses. How this trade-off should best be resolved deserves further research. But it may turn out to be optimal for central banks to guarantee fiscal authority debts in some situations.

The sovereign debt crisis and monetary policy

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Since Lehman Brothers' filing for Chapter 11 bankruptcy on September 2008, and as a result of the ensuing financial crisis and worldwide recession, policymakers all across the globe responded with a policy mix to better withstand the potential nefarious effects expected by experts and financial markets alike. The series of unprecedented phenomena since World War II resulted in a combination of automatic stabilisers and swift discretionary measures on the fiscal side, and accommodative policy on the monetary front.

Yet, over three years later, Europe does not seem more "off the hook" than any major advanced areas; and another crisis has emerged: the sovereign debt crisis. Because most euro area governments failed to abide by the Stability and Growth Pact rules prior to 2008, public indebtedness in the euro area countries has reached such a high level that sustainability and even solvency concerns have emerged, triggering a severe confidence crisis for the euro area periphery. At the same time, monetary policy is now close to its zero lower bound, so that there is little room for maneuver on this front.

These are exceptionally dangerous times because the euro area monetary policy now stands at a cross road. On the one hand, the legacy of the Lehman Brothers recession entails inflation risks due to fiscal dominance, central bank losses and the ensuing loss of credibility. On the other hand, it generates severe deflationary risks. Indeed, financial turmoil triggered by increased sovereign default risks has been conducive to a risk of credit crunch and might have impaired the monetary policy transmission mechanism.

Sustainability of government debt: preconditions for stability in the financial system and prices

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In Japan's case, the drop in the potential growth rate and concerns about the future tax and pension burden have given households and firms the incentive to spend less and save more. This has led to deflationary pressures and low interest rates. However, this situation is not sustainable in the long-run. A combination of measures to improve the longer-term fiscal outlook and to enhance potential growth needs to be implemented aggressively. The social costs of implementing such measures are large. However, if the government's fiscal outlook loses credibility, the costs would become even greater.

Regional and international dimensions

The importance of confidence in macroeconomic stabilisation efforts

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The intensification of the fiscal and financial problems in advanced economies, mainly in Europe, has deteriorated the prospects for global economic activity. In order to break the adverse feedback loop between the low economic growth, the fiscal crisis and the financial fragility, restoring confidence among economic agents is key. To this end it is crucial to adopt credible and comprehensive measures to consolidate fiscal accounts, to recapitalise troubled financial institutions and to repair private agents' financial positions. The recent agreements reached by European authorities move in this direction, but additional measures might be needed, which may require a greater participation of the International Monetary Fund. Latin America is a region that for decades suffered from recurring financial crisis that brought about hovering economic, political and social costs. The region learned its lesson and this time around has been able to sail through this period of world financial turbulence relatively unscratched. I claim that there are useful lessons that Europe could learn from Latin America´s experience in dealing with crises and setting the ground to avoid recurrences.

Policies on sovereign debt

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Because sovereign debt in advanced countries has reached unprecedented levels, there is more uncertainty than before on its future dynamics, and its impact on growth. As with any debt, it also creates the potential for increased financial fragility.

However, uncertainty does not translate into unsustainability. A "yes or no" approach to the question of sustainability will only lead to misapprehension and mistakes. In most cases, sustainability is fully endogenous to the set of policies implemented by governments themselves.

Policy frameworks, therefore, are even more important than before to anchor expectations and ensure financial and monetary stability. There should be no doubt or ambiguity about the willingness of the governments of advanced countries to pay their debts. And nor should there be any ambiguity on the preservation of monetary policies aimed at price stability. Clarity of purpose is especially important when central banks are still implementing exceptional non-standard measures and taking broader responsibility for financial stability.

Finally, there is an international dimension to public debt sustainability. Improving the international financial architecture will help the world reach a high growth equilibrium despite asymmetries in public debt levels and financial development. This should be a major priority on the international agenda.

Hazardous tango: sovereign-bank interdependence and financial stability in the euro area

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The strong interdependence between banking and sovereign crisis has emerged as a salient feature of euro area crisis. This interdependence, for sure, is not a specific feature of the euro area. But as pointed out by several authors the vicious cycle seems to be extremely strong in the euro area. The reason why euro area banks and sovereigns seem to be indissolubly tied together is twofold. On one hand, in the absence of a supranational banking resolution framework, member states keep individual responsibility for the rescue of their national banking system. Given the size of the banking systems across the euro area, this implies that the fiscal consequences of rescuing banks are potentially very large and explains how stress in the banking system can spill over to sovereigns. On the other hand, domestic banks hold on their balance sheets a considerable share of the debt issued by their domestic government. Any doubt about sovereign solvency immediately therefore affects domestic banks. This two-way bank-sovereign interdependence constitutes one of the specific features of the euro area that renders it especially fragile. In spite of this demonstrated weakness there has been surprisingly little policy action to remedy this state of affairs. Proposals for giving the European Union or the euro area responsibility for rescuing banks, or at least backstopping national authorities, have been consistently rejected.

Rebuilding growth and optimism in a new fiscal era

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We risk an unravelling of globalisation and its benefits, if we do not address with clarity the twin challenge of inclusive growth and sustainable public finances. Prolonged fiscal deleveraging in the advanced world is now inevitable, but it also greatly complicates the task of achieving inclusive growth. We have to build such growth, to bring back a sense of optimism in the advanced economies, and confidence in the global economy that they constitute the largest part of.

Fiscal policies therefore have to be renewed in purpose and scope. We have to move beyond the legacies of both the left and right. We need activist states, intervening boldly but on fewer tasks. The most important task must be to sustain social mobility by improving the breadth and quality of opportunities from young, and to help workers develop the skills and expertise that keeps them in demand in a global market. Broadening opportunities, rather than entitlements, has to be the defining purpose of the activist state.

Demand management remains critical in the current context, but will be most effective if focused on strengthening the supply-side capabilities that will spur longer term growth. We must keep the political narrative focused on the long term, on the social benefits of sustainable public finances, and on the need for a fair deal for our children.

Gaps in the institutional structure of the euro area

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The euro was created at a time when the conventional view was that a central bank could control inflation by controlling the money supply and that fiscal policy's interaction with monetary policy took the form of attempts to get the central bank to finance government debt. With a sufficiently firm and independent central bank, this view considered that financial markets would force discipline on fiscal policy. By creating a strong, independent central bank at the european level, facing multiple country-level fiscal authorities, the threat of political pressures for inflationary finance would be lower than with individual country central banks.

We are learning that this formerly conventional view was largely mistaken. In particular, the euro as originally structured seemed to require the elimination of national-level lender of last resort functions for central banks, without creating as strong a replacement at the european level. Having discovered these gaps through experience, what options are there going forward for the euro area? A solution would be to fill in the institutional gaps in the original euro framework. At a minimum, this would require a new institution with at least some taxing power, able to issue debt and to buy, or not buy, the debt of euro area governments. Such an institution would of course have to be subject to democratic control.

The euro crisis: some reflexions on institutional reform

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The debate on the euro crisis understandably has had a strong short-term focus. Avoiding short-term disaster has been tantamount and the long-term sustainability issue sometimes neglected; yet, the institutional failure of the euro area forces us to reconsider current arrangements in order to restore credibility and sustainability. The article discusses various paths for the reform of the overall governance, from fiscal management to banking regulation, through the recent proposals to mutualise and repackage part of the sovereign debts into a supranational one or to introduce joint-and-several liability.