THE SOVEREIGN DEBT CRISIS, FINANCIAL STABILITY AND FISCAL POLICY IN THE EURO AREA

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1. INTRODUCTION

This year's Annual Lecture of the Cyprus Economic Society takes place at a time when the European economy is at a critical juncture characterised by both positive and troublesome developments. On the positive side, economic recovery is gaining momentum globally and in Europe. Real GDP growth in the euro area is projected at around 1.6 and 1.8 percent in 2011 and 2012, respectively, which is close to its economy's potential growth rate. Banks' balance sheets overall have been strengthened substantially over the past few years. Equity markets are buoyant and property markets are stabilising. Hence, it would seem that the financial and economic crisis is almost behind us.

At the same time, there are a number of worrisome developments. Economic growth is very uneven across the euro area countries and is not sufficiently strong (given the existing economic slack) to help absorb the high unemployment rate, which is expected to remain at about 10 percent this year. Inflation has increased substantially over the past twelve months, averaging 2.8 percent in April 2011 in the euro area, mainly as a result of rising commodity prices. There are concerns that inflationary pressures may become broad-based and destabilise inflation expectations, which so far have been well-anchored to price stability. To address upside inflation risks, the European Central Bank raised its policy rates in early April. Significantly, a serious risk to Europe's economic performance and financial stability is that the sovereign debt crisis, which erupted in the euro area more than a year ago, has persisted and, indeed, intensified in recent months. The continuing tensions in the sovereign debt markets and the associated pressures in the banking systems of several euro area countries pose risks to economic growth and financial

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stability in the euro area as a whole. Thus, the key policy challenge being faced in Europe is how to effectively resolve the sovereign debt crisis and thus support economic growth, preserve price stability and protect financial stability in the countries under market pressure and in the entire euro area.

The financial and economic crisis of the past three years has bestowed a fiscal legacy on many advanced economies that poses very difficult, and in some cases daunting, macroeconomic and financial policy challenges. These are greater in the countries that pursued, before and during the global financial crisis of 2007–2009, very expansionary fiscal policies resulting in an excessive accumulation of public debt.

In my remarks, I will focus on the causes and financial stability consequences of the sovereign debt crisis in the euro area and on the challenges faced by policy-makers in their efforts to achieve fiscal consolidation, support economic growth, and safeguard financial stability in the European Monetary Union. Specifically, I will address the following questions. *First*, what were the main causes of the sovereign debt crisis in the euro area? In particular, what was the contribution of fiscal policies to the continuing pressures in sovereign debt markets? *Second*, where do we stand in the sovereign debt crisis today and what is the outlook for resolving it in the medium term? *Third*, what are the likely implications of the sizeable fiscal imbalances and persistent sovereign debt market pressures in a number of countries for the stability of the financial system in the euro area as a whole? *Fourth*, what are the main policy challenges confronted by countries under market pressure, notably Greece, as they strive to resolve their sovereign debt problems? Is there light at the end of the tunnel or is there a train coming from the opposite direction? *Fifth*, what are the lessons for fiscal policy from the debt crisis in the euro area? *Finally*, I will conclude with a few remarks on how the financial stability facilities being established in the European Union can help address the current policy challenges more effectively.

2. THE CAUSES OF THE SOVEREIGN DEBT CRISIS

The causes of the sovereign debt crisis in the euro area are fundamentally national in origin. At the same time, the crisis revealed that the economic policy framework, which had been established when the euro was introduced, had proved both ineffective and incomplete. It failed to coordinate national fiscal policies effectively so as to prevent excessive budget deficits and to correct them when they emerged. Moreover, it was incomplete because it did not adequately focus on the monitoring of other macroeconomic imbalances, such as the erosion of competitiveness in a number of countries and the associated emergence of large current account deficits, which became sources of instability and systemic risk.

The fiscal, financial and economic crisis experienced in Greece, Ireland and Portugal is partly a consequence of the effects of three common factors—although

the relative contribution of each differs across these countries—and partly a consequence of other determinants that are more country-specific. The first common factor is the substantial fiscal deficits and growing public debt due to either imprudent fiscal policies or as a result of the need to support financial institutions that had been adversely affected by the crisis. In the case of Greece, the size and persistence of budget deficits, reflecting irresponsible fiscal policies, was the main, though not the only, cause of the problem. In the case of Ireland, the asset quality of the banking system, which had become very large relative to the size of its economy, was the principal source of vulnerability with huge fiscal consequences.

The second common factor that caused the crisis was the significant erosion of cost competitiveness as measured by relative unit labour cost. It is interesting to note that the degree of erosion of competitiveness in the three countries currently with economic adjustment programs, but also in Spain and Italy, was roughly the same during the ten years following the introduction of the euro. This was partly the outcome of underlying economic forces, including the so-called "catching up" process, but mainly it reflected a lack of appreciation by policy-makers and social partners that the labour market practices being followed were incompatible with the requirements of the monetary union and the stability-oriented policy of the ECB. These practices would, therefore, inevitably have undesirable consequences for competitiveness, growth and employment.

The third common factor that contributed to the build-up of macroeconomic imbalances was the fast pace of credit expansion, which fuelled property price booms that turned into busts, adversely affecting fiscal positions as well as bank earnings and balance sheets.

An important point that should be kept in mind is that the recent experience demonstrated how these three factors—fiscal imbalances, labour market practices and excessive credit growth—interacted in a mutually reinforcing manner that worsened fiscal deficits and debt dynamics, either directly or indirectly, through their impact on housing markets, current account balances and economic activity.

The build-up of fiscal and financial imbalances in a number of euro area member states had become progressively evident well before the global financial crisis broke out, but appropriate corrective actions were not taken at the national level. Moreover, the Stability and Growth Pact proved ineffective both as a mechanism that would prevent excessive deficits and as a mechanism that would promote their timely correction. In 2004, the Pact was revised to become "more realistic and more flexible". Indeed, since then it was applied in a very flexible manner. At the same time, financial markets did not contribute to fiscal discipline as they underestimated, for a very long period of time, the risks associated with large and persistent fiscal deficits and excessive public debt accumulation.

To sum up and looking forward, the severity of the sovereign debt crisis in Europe is not the consequence of a significant deterioration of the fiscal position on

average in the euro area or in the European Union, which was considerable but not exceptionally big in the light of the impact of the global financial and economic crisis. The intensity of the sovereign debt crisis stems from the combined effects of large fiscal imbalances and sizeable competitiveness losses in a number of euro area countries, notably in Greece, Ireland, Portugal and, to a lesser extent, in Spain and Italy, and it reflects the constraints imposed by the single currency. These fiscal and competitiveness problems have to be resolved in a way which is consistent with those countries' membership in the European Monetary Union, which limits the potential policy instruments for dealing with them, even if such means are not ideal. Hence, to be specific, higher inflation and currency depreciation cannot be used to reduce excessive public debt and improve cost competitiveness. Consequently, the economic problems being faced by these countries must be solved by addressing the fundamental causes of fiscal imbalances and of the erosion of competitiveness. In my view, this is the appropriate and long-lasting way of doing so, although the short-term adjustment process is likely to be difficult.

3. THE CURRENT PHASE OF THE SOVEREIGN DEBT CRISIS

Where do we stand in the sovereign debt crisis in the euro area? The crisis is definitely not standing. It is rapidly evolving in an environment characterised by opposing, and rather contradictory, developments. On the one hand, appropriate and bold policy actions have been taken at both national and European levels in order to address the fiscal and competitiveness problems. On the other hand, and at the same time, there is increased uncertainty about the capacity and the willingness of countries to take the additional steps required to resolve the crisis. This uncertainty is partly fuelled by the public debate on a number of relevant issues, including the need for sovereign debt restructuring. In this public debate, politics and economics have combined in a complex, often confusing, and potentially damaging manner.

Over the past six months, pressures in the sovereign debt and CDS markets have intensified, despite the continuous implementation of significant fiscal consolidation measures in the three countries with the most serious debt problems, and despite the agreement that was reached at the March 2011 European Union Summit on a comprehensive package of measures to resolve the debt crisis. Thus, although a lot has been accomplished both at the national level and at the European level, markets, which are forward looking, have not been convinced that debt dynamics will be sustainable in the long run and that the governments' financing needs will be met over the medium term. Adverse market expectations about the prospects of resolving the debt crisis, accompanied by several credit rating downgrades of government securities and an environment of weak economic growth, are threatening to result in a self-fulfilling prophecy.

The key question is what further policy actions, both at national and European levels, can increase confidence in the sustainability of public finances in individual countries, facilitate the economic adjustment process and reassure markets that

"things will be under control", especially that financial stability and political cohesion in the euro area will not be threatened.

Recent experience has clearly demonstrated that decisive and convincing actions are necessary in order to change public perceptions and market sentiment in a favourable direction, which can help stabilise the situation and foster the resolution of the crisis.

4. SOVEREIGN DEBT RISK AND FINANCIAL STABILITY IN THE EURO AREA

Before providing some answers to this question, focussing in particular on the role of fiscal policy, I would like to briefly explain the systemic consequences of sovereign debt risk, that is why and how pressures in the sovereign debt markets can become a major source of systemic risk to the stability of the financial sector and the broader economy of an individual country, as well as threaten the stability of the financial system of the euro area as a whole.

The risks stemming from the pressures in sovereign debt markets pose significant systemic threats to financial stability through various contagion channels and as a result of adverse feedback between public finances, the banking system, the private capital market, and the real economy.

In a fiscally troubled country, perceptions of greater sovereign debt risk will not only result in higher financing costs for the government and larger budget deficits, thereby accentuating sovereign debt risk concerns, but they will also increase the cost of financing of the private sector from the capital market and the banking system, as government bond yields generally define a floor for the bond yields of firms headquartered in the same country.

Moreover, as sovereign debt market pressures grow, the risks faced by banks rise for several reasons, and, consequently, banks' financing costs correspondingly increase and their access to the wholesale funding market is restricted. Over the past twelve months, the relationship between sovereign risk premia and bank CDS spreads has become closer and very visible. The limited access of banks to the wholesale funding market induces them to curtail credit expansion and raise their deposit and lending rates, thus contributing to a further dampening of economic activity. This, in turn, lowers tax revenues and fuels market concerns about fiscal sustainability and the ability of banks to absorb liquidity shocks and maintain adequate capital buffers. These adverse feedback loops between the financial system, the real economy and the government sector augment the initial effects of rising sovereign debt risk on the banking system.

Turning next to cross-border contagion channels, the effects of increased sovereign debt risk of one country can be transmitted to other countries through exposures resulting from ownership links, foreign holdings of government bonds

and cross-border banking liabilities. In the euro area, these cross-border exposures are sizeable. For example, euro area banks hold about 50 percent of the stock of long-term bonds issued by euro area governments and they are the largest holders of short-term sovereign debt. Moreover, in a number of countries banks have also extended significant amounts of loans to the public sector. The potential cumulative cross-border impact of sovereign risk depends not only on the size of exposures but also on the extent of changes in market valuations. If government bond yields change substantially and simultaneously in several sovereign debt markets, due to a generalised erosion of confidence in the ability and willingness of countries to restore sound public finances, the implications for the stability of the financial system of the euro area as a whole will be significant.

To summarise: (1) as a result of various adverse feedback mechanisms at work, between sovereign debt markets, public finances, the banking system and the real economy in individual countries, and (2) as a consequence of several cross-border contagion channels, increased tensions in bond markets and banking systems in one or more euro area countries are likely to have a bigger impact on the financial system of the euro area as a whole than is suggested by the size of cross-border bank exposures. The reason is that confidence effects and changes in the valuation of a wider range of assets than the sovereign debt of an individual country can have significant implications for financial stability and economic activity in the euro area as a whole and beyond, particularly in emerging Europe.

5. THE GREEK SOVEREIGN DEBT CRISIS AND ITS RESOLUTION

Let me now turn to the main policy challenges currently confronting the fiscally troubled countries. What game changing policies can contribute to the resolution of the sovereign debt crisis? I will answer this question by focussing on the Greek case and then draw some lessons for fiscal policy that are especially relevant to other countries that are, or may come, under market pressure.

One year after the agreement on official financial support and the adoption of an ambitious economic adjustment programme, Greece is confronted, once again, with extraordinary challenges. Market conditions, as measured by bond yield spreads and CDS premia, have deteriorated substantially over the past few months and they are now worse than a year ago. The deterioration in market sentiment has taken place despite an impressive reduction in the budget deficit by 5 percent of GDP in 2010 and the implementation of important pension system and labour market reforms. Apparently, the fiscal consolidation and reform efforts have not been sufficient to convince markets about the sustainability of public finances.

What factors or events account for these unfavourable market developments? And what are the policy implications? Market participants and economic analysts are concerned about implementation slippages and delays over the past six months. They also worry that adjustment fatigue, political uncertainty and social tensions

will make it difficult to reduce the budget deficit and control debt dynamics effectively. In addition, concerns have been expressed that an inefficient public administration and the lack of political consensus on the adjustment programme will hinder the attainment of fiscal targets and the implementation of the reform agenda that can boost economic growth over the medium term. As a result, market participants and some commentators have expressed the view that a vicious circle of lower-than-expected growth and higher-than-planned budget deficits will take hold and lead to unsustainable debt dynamics. Some of these concerns admittedly are based on facts and will have to be effectively addressed to make further progress in achieving policy goals and reassure markets about the resolution of the debt problem. Other concerns, however, are based on exaggerated assessments or misperceptions of reality.

Over the past few months, two other factors, partly related to the previous concerns, have also contributed to the increase in market pressures. The first is the debate about the desirability, necessity or inevitability of debt restructuring. The second is the speculation about the absurd and purely hypothetical scenario of Greece abandoning the euro. Let me make a few remarks on these two issues.

The option of Greece exiting the euro area has already been dismissed as an absurdity by all responsible authorities both in the European Union and in Greece. It is not legally feasible and such a hypothetical possibility would have adverse consequences both for the Greek economy and for the European monetary union. It is thus a non-option. Hypothetical scenaria and associated discussions of this issue contribute to public confusion and, hence, are not helpful.

The debate on debt restructuring has been extensive and intensive in recent weeks. Debt restructuring can help relieve the country's debt burden and facilitate the fiscal adjustment process. Some proponents of debt restructuring consider it desirable, others necessary in order to address medium-term funding problems and others inevitable given the size of Greek public debt and doubts about its sustainability. The proponents of debt restructuring, however, have not taken sufficiently into account the fact that the participation of Greece in the European Monetary Union and the composition of its debt by holder imply that a debt restructuring entailing haircut losses for the holders of government securities will also have adverse consequences for the banking system and the broader economy. At present, debt restructuring does not seem necessary and it can entail real costs and potential risks that could be significant relative to expected financial benefits.

It is important that the benefits, costs and risks associated with debt restructuring should be carefully assessed. Let me mention some costs and risks. *First*, as a consequence of the distribution of government debt by holder, part of the resulting losses from a debt restructuring will ultimately be borne to a considerable extent by the government and taxpayers, which will directly or indirectly have to cover these losses. *Second*, in a monetary union the restructuring of the government debt of one country is likely to have strong spillover effects on the sovereign debt

markets and banking systems of other fiscally troubled countries and, hence, have a systemic impact on the financial sector of the euro area as a whole. *Third*, there is a risk that debt restructuring could undermine the appropriate focus and the strong effort required to deal with the root causes of fiscal imbalances and structural weaknesses.

Looking ahead, the sensible way forward is to proceed with the implementation of the economic programme that will effectively address the fundamental causes of fiscal imbalances and improve the competitiveness of the Greek economy, which should jointly underpin economic recovery and strengthen growth performance. This will take some time and require further effort, but the final outcome of the adjustment process will be higher and sustained growth. To this end, effective implementation of measures, political consensus and improved communication to the public about the objectives and the ultimate benefits of the policies pursued are key ingredients for the success of the adjustment effort. If the economic programme, including the planned and ambitious privatisation of public enterprises and the sale of state assets, is implemented fully, effectively and consistently over time, the uncertainty about the commitment and the capacity of the government to achieve its objectives will be reduced, market conditions will improve substantially and economic recovery will be brought forward. If, however, policy implementation is ineffective, high uncertainty persists and confidence remains low, the economic growth outlook will deteriorate and debt restructuring will become necessary.

I examined at some length the policy challenges confronted by Greece not only because at present they are discussed extensively, but also because the Greek experience before and during the financial crisis offers lessons for fiscal policy that are instructive and broadly relevant to other countries, especially euro area countries under market pressure.

6. LESSONS FOR FISCAL POLICY FROM THE DEBT CRISIS

What are the lessons for fiscal policy from the sovereign debt crisis in Europe? The general lesson is that sound and sustainable public finances are essential both for durable economic growth and financial stability. This proposition—obvious ex post but evidently not sufficiently understood and adhered to ex ante—is supported by theoretical analysis and the available empirical evidence.

Let me draw some specific lessons:

First, the effectiveness of fiscal policy in stimulating aggregate demand and stabilising the economy declines as public debt relative to GDP increases. When the debt-to-GDP ratio becomes excessive and markets seriously doubt the sustainability of debt dynamics, the net impact of an expansionary fiscal policy on economic activity diminishes sharply and may progressively become nil. In other words, the Keynesian multiplier is not only less than one, but may approach zero. If we examine the growth performance of the Greek economy in the four years before the

debt crisis broke out in the spring of 2010, we observe that as government expenditure and the budget deficit increased, economic growth steadily declined. The stronger stimulus did not support economic activity due to growing indebtedness and changing financial market conditions. The available evidence from other countries supports the validity of the first lesson.

Second, the debt-to-GDP ratio is not a sufficient statistic for assessing the sustainability of public finances. It is important to take into account the likely evolution of the debt ratio in view of implicit future liabilities of the government related to the ageing of population and features of pension and health care systems.

Third, recent experience has clearly demonstrated how quickly the debt-to-GDP ratio can deteriorate during a financial and sovereign debt crisis, as a result of interactions between the banking system and public finances. Ireland and the United Kingdom offer characteristic examples. Before the crisis the debt-to-GDP ratio in Ireland was very low, 25 percent of GDP in 2007, but over the past three years it has risen dramatically and is forecast to exceed 100 percent in 2011.

Fourth, fiscal consolidation should give priority to government expenditure reduction for this provides the most effective means of achieving an improved fiscal position in a sustained manner. Of course, this does not imply that efforts should not be made to increase tax revenue by fighting tax evasion and tax avoidance and by introducing reforms to improve the efficiency of the public sector.

Fifth, fiscal consolidation policies should emphasise reforms that address the root causes of fiscal imbalances and should not rely mainly on temporary and reversible measures. Fiscal reforms are necessary in order to reduce budget deficits in a permanent manner and to convince markets and the public that the government is really serious about putting public finances under control.

Sixth, it is vital to combine fiscal consolidation measures with structural reforms that can help improve the economy's competitiveness and strengthen its productive potential. Growth-enhancing structural reforms and fiscal consolidation measures will be mutually reinforcing, thus facilitating the adjustment process and minimising economic and social costs during the adjustment period.

Seventh, it is essential to embark on the implementation of appropriate fiscal consolidation measures and structural reforms in a timely and convincing manner well before the crisis erupts and as soon as debt dynamics appear unsustainable.

The last lesson brings me to a point I would like to make on the Cypriot economy. During the decade before the global financial crisis broke out, the growth performance of the Cypriot economy was remarkable and its public finances were sound. Indeed, in 2007 economic growth was about 5 percent and the general government budget was in surplus equal to 3.5 percent of GDP. There were, however, signs of macroeconomic imbalances indicated by rising inflation, which reached 4.4% in 2008 and by a sizeable current account deficit, which exceeded

15% of GDP in 2008 and remained at around 10% of GDP in the following years. These macroeconomic imbalances were revealed during the global financial crisis.

At present, Cyprus is facing serious policy challenges, mainly stemming from the sharp deterioration in public finances, with the government budget deficit at 5.5% of GDP in 2011, as well as from the sovereign debt exposures of its large (relative to the size of its economy) banking system. It is encouraging to learn that measures have been taken by the Central Bank of Cyprus and other policies will soon be introduced by the Ministry of Finance to protect financial stability and consolidate public finances. The experience of Greece and other euro area countries with sizeable fiscal imbalances and vulnerabilities in their banking systems shows that it is essential to implement the appropriate policies promptly, effectively and consistently over time. Moreover, the lessons from the crisis, as well as today's credit rating downgrade, strongly indicate that there is no time for complacency. What is needed is decisive and effective policy action.

7. FINANCIAL STABILITY FACILITIES IN THE EURO AREA

I argued before that the full, effective and consistent implementation of credible fiscal adjustment and reform programmes in individual member states experiencing a sovereign debt crisis should result over time in a steady and substantial improvement in market conditions. However, we cannot be sure that this expected improvement will be sufficiently rapid to make possible the funding of sizeable borrowing requirements of governments over the next two years at a reasonable cost.

To support the economic adjustment process in all countries under market pressure and speed up the resolution of the debt crisis in the euro area, it would be desirable that the functions of the temporary European Financial Stability Facility (EFSF) and the future permanent European Stability Mechanism (ESM) are expanded in order to allow greater operational flexibility to intervene in secondary bond markets. The main objective would be to help improve market functioning, since during periods of stress and uncertainty these markets can become illiquid and dysfunctional, occasionally influenced by expectations that diverge from fundamentals. By reducing pressures in sovereign bond markets, fiscal consolidation and bank credit provision would be facilitated.

In addition, the provisions of the European Stability Mechanism concerning the potential involvement of the private sector in the case that a sovereign debt is assessed insolvent should be amended. Although these provisions are appropriate in the long term in order to reduce moral hazard, their envisaged introduction in 2013, while currently market tensions persist and uncertainty is high, would likely have undesirable, and surely unintended, consequences for financing costs, thus hindering the resolution of the debt crisis.

8. CONCLUDING REMARKS

Let me conclude with two observations of a general nature. *First*, theoretical arguments, empirical evidence and recent experience strongly suggest that sound and sustainable public finances are essential for supporting durable economic growth and safeguarding financial stability. It is vital that policy actions should be taken to ensure debt sustainability during the good times and not under market pressure and in response to an emerging debt crisis. *Second*, although the road to resolving the debt crisis in the euro area will not be easy and will take some time, I am convinced that the crisis will be effectively resolved because European leaders and institutions realise that there is no other option. They will, therefore, take the appropriate actions, at national and European levels, to overcome the problems currently faced and prevent the recurrence of another debt crisis in the future. All euro area countries have a common interest in preserving the stability and credibility of their single currency.

FROM LONDON TO THE CONTINENT: RANKING EUROPEAN ECONOMICS DEPARTMENTS ON THE BASIS OF PRESTIGIOUS MEDALS AND AWARDS

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This study ranks the top 20 European economics departments on the basis of five prestigious awards won/held by these departments' current faculty: the *Nobel Prize in Economic Sciences*, the *Yrjö Jahnsson Award*, the European Economic Association's *Presidency*, the European Economic Association's *Alfred Marshall/Joseph Schumpeter Lecturers* and the European Economic Association's *Hicks-Tinbergen Medal*. Based on our methodology, the London School of Economics is the top economics department in Europe. Rounding out the top three European economics departments are the University of Bonn and the University of Cambridge, respectively.

JEL classification: A10, A11, A14

Keywords: ranking European economics departments, Nobel Prize in Economic Sciences, Yrjö Jahnsson Award

1. INTRODUCTION

Dusansky and Vernon (1998a, p. 157) claim that "[m]any academics publicly claim to hate rankings, even while they privately pore over them." The subsequent fiery debate surrounding Dusansky and Vernon's (1998a) economics department ranking provides a good indication of the varying tastes found in the rankings literature in economics (see Feinberg 1998; Griliches and Einav 1998; Dusansky and Vernon 1998b). Yet, academic rankings can be important given that they serve as a basis for attracting and retaining top faculty and graduate students, and are often used by university administrators to allocate scarce educational funds (Kalaitzidakis, Mamuneas and Stengos, 2003).

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