A LAWMAKER'S GUIDE TO THE NEXT FISCAL CRISIS

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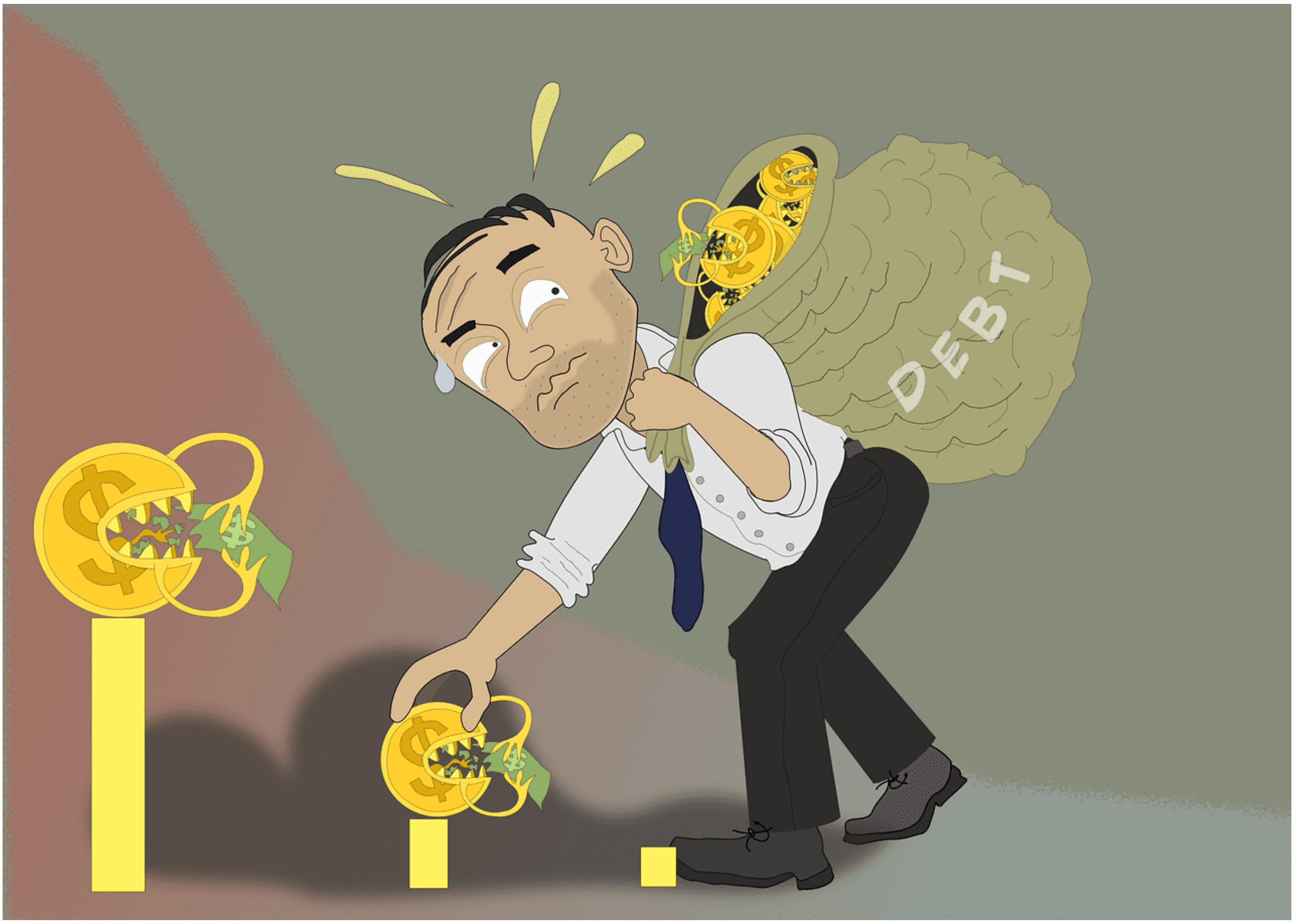

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There is no denying anymore that the European economy is heading into a recession. The jury is still out on just how serious it is going to be: some suggest it will not be that bad while others are more pessimistic, about Europe in general as well as individual member states.

I am one of the pessimists. I hope for the best, of course, and if inflation tapers off in the coming months, the recession will be less severe. Eurostat's latest inflation update gives some credence to that scenario, and it would be about time: the American economy reached the peak of its inflation episode last summer.

That said, even a relatively moderate recession can turn ugly. When the economy hits the downslope for real, there is one variable that will decide just how bad it gets: the deficit in government budgets.

In the economic crisis a decade ago, often referred to as the Great Recession or the 'financial crisis,' governments across Europe focused all their fiscal policies on shrinking the gaps in their budgets. Three big international actors—the EU, the ECB, and the International Monetary Fund (IMF)—teamed up and forced the most deficit-ridden governments into harsh spending cuts and heavy tax hikes.

These so-called austerity measures aggravated an already serious crisis: they took money from households and businesses when they needed that money the most. As I explained in my review of the Greek economy, a decade after the crisis, austerity was exactly the wrong response to the crisis.

Europe simply cannot afford another austerity episode. Every government with debt on hand, and especially those with debt levels that are already unsustainable, must get to work on a contingency plan for the coming recession. Legislators, members of governing cabinets, prime ministers, presidents—they should all be proactive and at all costs avoid being taken aback this time.

It was the lack of preparedness, and the lack of understanding of what a fiscal crisis is that led Greek, Spanish, Portuguese, Cypriot, French, Italian, even Dutch lawmakers to make serious policy mistakes. In some cases, those mistakes had crippling effects that their countries have not yet recovered from. Greece lost one-quarter of its economy; today, Greek families are struggling to maintain a standard of living comparable to what they had 20 years ago.

Greece was not the only country hit hard by the last crisis. Today, an austerity-driven crisis would spread to more countries, with more serious consequences in general. If policymakers across Europe learn from their mistakes back then, and if they follow a couple of simple points of advice, they may very well save not only their own countries, but Europe as a whole, from another crippling macroeconomic disaster.

How a fiscal crisis begins

Before we get to the alternative to austerity, it is important that we remember how a fiscal crisis starts in the first place.

Its technical beginning is the moment when investors in the sovereign-debt markets lose faith in a government's treasury securities. This loss of faith can show up in different forms, but an obvious exhibit is when a government cannot sell all of the debt it offers.

Here is how it works. Suppose the government of Jamtland has €1200 in debt. It consists of one-year treasury bills, divided into 12 staggered batches of €100 each. These are sold month by month, so that over one year the treasury has 'rolled over', i.e., renewed, its entire debt.

Suppose also that the Jamtland government sells its monthly €100 with a promise to pay the holder of the debt a coupon of €3 per year. This practical formula,

tells us that the debt holder gets a 3% return on his investment.

At every monthly auction, investors show up and make tender offers—pledge to buy—all the €100. If they tender more than €100, the bond price will go up; since the coupon payment is a fixed nominal amount, this means that the yield falls.

Suppose instead that one day, investors show up at the Jamtland treasury's auction with only €90 worth of tender offers. This time the price falls, forcing the yield up.

This is the scenario that interests us. It is not the normal state of affairs on sovereign-debt markets; at most auctions for highly credible government debt, investors offer to buy more than what the government wants to sell. If the excess demand for debt is moderate (again, the normal situation) the yield remains stable over time.

That changes when there is less demand than supply of treasury bonds. As is always the case in economic activity, negative news—such as a government failing to sell all the debt it auctions off—affects the economy more rapidly than positive news. Economic theory explains this in psychological terms: when there are not enough takers at an auction of government debt, investors grow worried that other investors are losing interest in holding, let alone buying that debt.

At this point, investors grow concerned that they will not be able to sell the treasury securities they hold in their portfolios, at least not at a price that preserves the value of their investment. Therefore, they rush to the market and try to sell them earlier than they planned. This increases the supply of debt on the market; the price of the bond falls, pushing yields (interest rates) up.

The flight of investors away from the Jamtland government's debt is all that is needed to put that government in a fiscal crisis. All it takes is a big enough flight away from their treasury securities.

Once triggered, a fiscal crisis easily gains momentum. It will only stop when the market hits rock bottom (an unpredictable point) or when an external force starts buying enough of the Jamtland government's debt to restore confidence in it.

The European Central Bank did just that during the Great Recession. Its enormous purchases of sovereign debt resulted in an unprecedented expansion of the money supply in the euro zone. The ECB now sits on a substantial portfolio of debt that it cannot get rid of, especially not when another fiscal crisis may be in the making.

As a result, the ECB is now *de facto* prohibited from buying more debt. With the central bank ruled out, conventional political wisdom leaves the debt-ridden government with only one option: austerity measures. They were used vigorously by several governments in the last crisis, with the sole purpose of eliminating the budget deficit as soon as possible, no matter the cost.

Austerity did not work. Only the ECB's intervention prevented a full-fledged disaster on the sovereign-debt market in the EU. Now, with the central bank out of the picture, the need for an alternative strategy is higher than ever.

The main reason for this is, of course, the looming recession, but an equally compelling reason is that 14 out of the EU's 27 member states have a debt that exceeds the constitutionally mandated cap of 60% of GDP:

Figure 1

Source of raw data: *Eurostat*

If the legislators in the excess-debt countries take no proactive measures, they could rapidly find themselves in as bad a situation as Greece did last time. Or worse.

An alternative strategy

The essential component in a fiscal crisis is the loss of investor confidence. It is not the cause of the crisis—that is excessive indebtedness—but it is the mechanism that sets the crisis in motion. To prevent that from happening, Europe's deeply indebted governments must secure sustainable funding for their deficits.

Focusing on the euro zone, the key to an alternative deficit-funding strategy lies in the yield curve on the market for euro-denominated sovereign debt. As Figure 2 reports, this curve has the normal upward slope (blue), unlike the American yield curve, which slopes downward (red):

Figure 2

Sources: *U.S. Treasury; Eurostat*

These two yield curves represent, at least in part, inflation expectations among investors. When they expect inflation to decline over the long term, they accept lower yields on securities with long maturity. They still demand high yields on short-term debt, which leads to the inverted yield curve.

At present, this is the case in America. The U.S. economy passed its inflation peak in June (per data from the Bureau of Labor Statistics), while Europe has just about reached that point. Therefore, the preferences are reversed among debt investors in the euro zone: investors still demand higher rates on long-term commitments than when they buy for the short term. While this is the 'normal' state of affairs in a debt market, it is also the natural spread of expectations when investors are unsure of how long an inflation episode will last.

Indebted governments within the euro zone can take advantage of this. As a step toward easing or, hopefully, avoiding a debt crisis altogether, they can concentrate the issuance of new debt to the longest end of the maturity spectrum. Since bonds with a life of 20 years or more presently pay more than 3% (again using Eurostat averages; yields for individual countries may vary), it is a good selling point to investors that these yields will last long after the current inflation episode is gone. At that time, when inflation returns to its 1.5-2% 'normal' range, these bonds will pay a nice positive interest rate.

There is one more reason for deeply indebted governments to concentrate their new debt to the longest maturities. When inflation subsides and more people want to buy its debt, the market price will increase. Per our formula above, this means that the yield falls again, which means that those who invested in the debt during the crisis can reap a capital-gain profit.

Not only does this make financial sense, but it is also good 'political psychology': it shows that the government in question has the long term in mind when making fiscal policy decisions. The cost to the government is a bit higher upfront compared to if the government had sold short-term debt at lower interest rates. However, if they had done that, they would have had to roll over—renew—their debt in the thick of the recession. This would sharply raise the cost of their debt instead of keeping it stable and predictable over time.

Finding new investors

But who will buy this debt? If the central bank is ruled out, and if established investors are skeptical of buying more, or even sticking to the portfolios they have, who would possibly step up to the plate?

The primary investor demographic would be households and domestic businesses. Uncertainty about the future is one of the most harmful components of a recession: households are increasingly concerned about employment; businesses hold off on investments and new hirings, even lay off workers. Financial security is paramount, providing a platform for renewed confidence among economic decision-makers.

A government that directs its treasury to sell a tailored package of new, long-term debt to households with higher-than-average income and businesses with good liquidity positions, can make significant progress toward avoiding a fiscal crisis. Once this program goes to work, regular investors will see that there is good liquidity in the sovereign-debt market. As a result, they will return to it earlier than they otherwise would, thereby reinforcing the indebted government's ability to get through the recession without having to endure another fiscal crisis.

This is, of course, not the only step a government needs to take. It has to ensure that its long-term fiscal outlook is better than in the past: by means of structural reforms to government spending, it can reduce the likelihood of budget deficits going forward.

By encouraging economic growth through deregulation, responsible tax cuts, and limited privatizations of programs currently funded by taxpayers, a government can put even more distance between itself and future debt crises.

Again, it is paramount that legislators in Europe's heavily indebted countries go into the coming recession with a proactive mindset. This also means that legislators cannot leave the management of their nation's debt to the experts; it was the experts who brought about the austerity disaster last time. Chances are they have not learned the lesson since then.