THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
888 16th Street, N.W., Suite 740
Washington, D.C. 20006
Phone: 202-861-0791 • Fax: 202-861-0790
www.international-economy.com
editor@international-economy.com

Papademos: An *Exclusive*

Lucas Papademos *served as Vice President of the European Central Bank from 2002 to 2010.*

TIE: **With European policymakers calling for aggressive budget austerity, and with most of the world rejecting the American call for additional fiscal stimulus, is the world at risk of a so-called double-dip economic recession scenario, or perhaps even a depression?**

Papademos: Let me first point to some facts before assessing the scope for fiscal stimulus and the potential risks of fiscal consolidation to economic growth. The economic and financial crisis has resulted in a significant deterioration in public finances in most advanced economies. In a number of countries, including the United States and several EU member states, government budget deficits as a percentage of GDP approached or exceeded double-digit levels in 2009 and in many cases no discernible improvement is expected this year. If decisive measures are not taken to reduce government budget deficits in the years to come, market concerns about the sustainability of public finances will eventually translate into higher risk premia and real bond yields, with adverse effects on economic activity. This has already happened in countries where debt dynamics have been assessed as particularly unfavorable.

These facts and likely future market outcomes show that the room for further fiscal stimulus is either extremely limited or nonexistent. On the contrary, there is a need for fiscal consolidation in most advanced economies. Unless sizeable and credible fiscal consolidation is implemented to address the risk of rising public debt and unsustainable debt dynamics, growth will be adversely affected. Since fiscal adjustment is inevitable—and the extent of the required adjustment will be greater the more it is delayed—markets and the public at large are likely to adapt their behavior to this prospect sooner rather than later. It is dangerous to assume that the majority of consumers and investors are short-sighted and that they will ignore the future consequences of rising public debt on the real cost of financing and

The retiring European Central Bank Vice President speaks out on the European banks, chances for a double dip, and the survival of the euro.

Interview

the evolution of real income. Consequently, both private consumption and investment could turn out—and in some countries will surely turn out—to be weaker over the medium term in the absence of prompt fiscal consolidation. Moreover, the prospect of high and increasing debt-to-GDP ratios could raise concerns about future inflation and unanchor long-term inflation expectations from price stability.

Indeed, a strong case can be made that, under the circumstances prevailing in many economies, systematic and convincing policy action to address the large budget deficits will reduce uncertainty, boost confidence in the sustainability of public finances, and thus foster conditions conducive to economic growth. I do not see a so-called double-dip economic recession scenario as the likely outcome of pursuing policies of budgetary prudence that will prevent a serious fiscal and economic crisis in the future.

***TIE:* What are the odds the euro survives? How about the chances that certain members of the monetary union drop off? What will the European monetary system look like five years from now? If the eurozone shrinks, will Germany face serious deterioration in its export markets as exiting countries engage in currency depreciation against the euro to counter rising bond yields?**

Papademos: The euro is here to stay. It is totally unrealistic, indeed absurd, to doubt the euro's survival. No member of the European monetary union will "drop off" and abandon the single European currency. Such a prospect is not legally feasible. More importantly, there are no convincing economic and political incentives for member states to do so. The arguments that have been advanced by some economists, including distinguished friends of mine, are based on partial assessments that do not take fully into account all the relevant economic and political consequences of such a hypothetical scenario, as well as the commitment of all euro-area countries, despite the recent difficulties and tensions, to the European integration process.

It is, of course, true that some euro-area countries—notably but not exclusively Greece—will have to implement

I do not see a so-called double-dip economic recession scenario.

ambitious fiscal adjustment programs and wide-ranging structural reforms to improve their fiscal situation and international competitiveness in order to enhance their economic performance within the euro area. These countries are taking significant steps to this end. I am convinced that the required adjustment efforts and associated short-term costs would have to be greater outside monetary union. It is an illusion to expect that there are easier policy responses, based

If decisive measures are not taken to reduce government budget deficits in the years to come, market concerns about the sustainability of public finances will eventually translate into higher risk premia and real bond yields, with adverse effects on economic activity.

on abandoning the euro and adopting a devalued national currency, that can more effectively address the challenges faced by some euro-area countries. Theses challenges fundamentally reflect structural economic weaknesses and social attitudes that are the consequence of persisting inappropriate practices in markets and the public sector, which are not compatible with the stability-oriented single monetary policy of the European Central Bank.

The economic and institutional foundations of the European monetary union can and should be reinforced. This can be done by implementing reforms to improve the functioning of labor and product markets and by strengthening the institutional framework for economic surveillance and policy coordination across the euro area. It is in the interest of all member states to improve the functioning of the European Monetary Union. The Task Force on Economic Governance under the Chairmanship of the Council President Herman Van Rompuy will make proposals that will contribute to this end. This is the only sensible way forward for Europe and the global economy.

TIE: **Germany has been the leader in insisting that the flaw in the system of monetary union is the lack of fiscal discipline. Do you agree? To what extent has the lack of a political union to accompany monetary union become the euro's Achilles' heel? Did European policymakers underestimate the difficulties of achieving a permanent monetary union without a political union including common fiscal policy and labor market reforms? Politicians in Berlin have passed legislation limiting federal borrowing to 0.35 percent of GDP by 2010. Will this action alone place further destabilizing pressure on the monetary system?**

Papademos: There is no doubt that insufficient fiscal discipline has created tensions in the sovereign debt markets that have adversely affected the liquidity and functioning of banking systems and impaired the transmission of the single monetary policy across the euro area. There is clearly a need to address these problems by restoring sound public finances in member states and establishing a policy framework that will effectively encourage the implementation of disciplined fiscal policies in the years to come.

This is necessary, but not sufficient. There is also a need to foster labor market policies across the euro area that are compatible with the European Central Bank's monetary policy that aims at, and has succeeded in, preserving price stability in the euro area as a whole, that is, an inflation rate below, though close to, 2 percent. If wages and unit labor costs in member states persistently increase at a pace that is higher than the rate consistent with price stability, the resulting erosion of cost competitiveness will adversely affect economic growth in those countries and the smooth functioning of monetary union.

A higher degree of political integration would facilitate the implementation of the appropriate fiscal policies and labor market reforms that would better underpin the functioning of monetary union. Since a political union and a common fiscal policy are not envisaged in the foreseeable future, the practical approach to addressing the problems exposed by the crisis is to establish effective and robust mechanisms to foster fiscal discipline and appropriate reforms. Recent experience has taught political lessons that should help create the right policy framework and use it in an effective manner.

The legislation that was passed in Germany should exert further pressure to implement disciplined fiscal policies. It should have a stabilizing—rather than destabilizing—effect on the European monetary union. Other member states have their own good reasons to reduce their fiscal deficits drastically.

TIE: **To what extent did the ugly balance sheets of European banks make the most logical solution to the Greek financial crisis—so-called haircut arrangements to restructure sovereign debt—impossible?**

Papademos: The characterization of European bank balance sheets as "ugly" does not reflect reality. Also, I do not agree with the view that a restructuring of Greek sovereign debt is the "most logical solution" to the Greek financial problem. Some European financial institutions may be more exposed than others to different types of credit risk, including sovereign credit risk. But it is not right to generalize and overstate the magnitude of the problem. The exposures of individual institutions are not the reason for not opting for sovereign debt restructuring. Such an option may help alleviate short-term pressures but will have undesirable economic and political consequences in the longer run.

TIE: **Critics have charged that the European banks have continuously overestimated the value of assets on their balance sheets—including loans to Eastern European and Baltic states. Are the European banks, and thus monetary union and the euro, set for even more difficult times ahead?**

Papademos: The recorded write-downs of European banks on their securities and loans since the beginning of the crisis have been substantial. To be more specific, the total write-downs of euro-area banks on securities and loans reported from the start of the crisis in 2007 until the end of April 2010 were €187 billion, and euro-area banks had also made loan loss provisions of €238 billion in the three years 2007–09 for the deterioration in the quality of their loan exposures.

Looking ahead, the latest estimates of the ECB published in the Bank's June 2010 *Financial Stability Review* suggest that the potential further write-downs of euro-area banks on their loans could reach €123 billion in 2010 and €105 billion in 2011, reflecting to a considerable extent possible losses on corporate and consumer loans and commercial property mortgages. Interestingly, the International Monetary Fund has produced comparable estimates when appropriately adjusted for differences in the periods covered and certain technical assumptions. Authorities have been transparent about their estimates concerning potential losses at the aggregate level based on the central macroeconomic scenario and given the available information. Needless to say, all such estimates of potential future losses are subject to uncertainty and must be interpreted with great caution. The results of the stress tests to be completed in July will provide further relevant information on the possible outcomes for ninety major institutions in the event that a more "stressed scenario" materializes.

It is totally unrealistic, indeed absurd, to doubt the euro's survival.

TIE: **To what extent is the monetary union vulnerable to different cultural attitudes (for example, perhaps Greek workers culturally are incapable of rising to the competitive levels of their German counterparts)?**

Differences in social or cultural attitudes and in market practices across countries in a monetary union can explain to some extent the divergencies observed in wage and unit labor costs over time. But the relative contribution of different cultural attitudes should not be exaggerated. Most countries with rapidly rising unit labor costs have actually recorded significant gains in productivity over the past ten years, but nominal wages had increased even faster because of "catching up" effects and inappropriate labor market practices that had not taken into account the "new nominal regime" established after the introduction of the euro. I expect that the experienced consequences of diverging labor cost developments will foster a better understanding of the new reality and result in more appropriate and compatible labor market policies and practices. More information and education about the constraints imposed by the new monetary environment and their implications for the functioning of the economy are certainly warranted.

TIE: **Is Spain a ticking time bomb, given that only 10 percent of its debt is sovereign debt? Spain already has an unemployment rate exceeding 20 percent, with deficits measuring 10 percent of GDP. How much labor market reform is even possible? Will Spain (and thus the euro) fall further victim to a further deteriorating Spanish housing crisis?**

Papademos: Spain is facing a number of challenging and, to some extent, unique problems. But decisive action has recently been taken to tackle the budget deficit at a faster pace than previously planned and to reform the labor market so as to help reduce the very high unemployment rate. The crisis has catalyzed a reorientation of policy and a front-loading of the reforms needed to underpin a sustained increase in activity in the years to come.

TIE: **The European Central Bank recently changed its rules and is allowing Greek banks to continue to use their sovereign debt, now graded as junk, as collateral for borrowing. Is this the first step toward politicizing the central bank?**

Papademos: Absolutely not. This measure was not motivated by political considerations. It was taken to safeguard the stability of the euro-area banking system as a result of pressures experienced in a segment of it and in order to ensure the smooth transmission of monetary policy. This measure is temporary and was taken to address a crisis

Continued on page 47

Continued from page 29

situation and to prevent potential risks to the stability of the euro-area financial system stemming from the funding constraints on the Greek banking sector that were not the consequence of banks' own actions but of pressures in the sovereign debt market. The European Central Bank's decision was also based on the fact that the Bank together with the European Commission and the International Monetary Fund had approved the economic adjustment program that had been negotiated with the Greek government and aimed at restoring sound public finances and ensuring fiscal sustainability. It would have been inconsistent to approve such a program whose implementation reduces the sovereign credit risk of the country and, at the same time, not to accept that country's government debt as collateral for providing short-term funding to banks, even when rating agencies assess the credit risk differently.

TIE: **Are you surprised that Italy's sovereign debt has held up as well as it has?**

Papademos: A number of factors account for this fact. First, Italy's budget deficit is relatively low: it was 5.3 percent of GDP in 2009 and it is expected to decline steadily in the coming years, especially after the additional measures announced by the Italian government. Second, Italy's sovereign debt market is deep and liquid, while the bulk of government securities are held by residents, including institutions that are likely to hold these securities to maturity.

TIE: **In Germany, credit demand has been collapsing. Between now and the end of 2012, will the danger facing the eurozone be more disinflationary than inflationary?**

Papademos: Developments in bank credit and broad money in the euro area over the past few quarters indicate that inflation pressures are likely to remain contained over the medium to longer term. The reduced demand for credit, which has been the main driver of the sluggish—even negative over some periods—growth of credit extended to the private sector, does not imply deflation risks for a number of reasons. First, it reflects the past weakness of economic activity and the current subdued aggregate demand, and the fact that in some countries, including Germany, firms can finance their investment by retaining earnings or by borrowing directly from the market. As economic activity picks up and investment prospects improve, the demand for credit will correspondingly increase. What is, of course, important is that banks are able and willing to meet the higher demand for loans as the economy recovers. This will depend on the completion of the deleveraging of their balance sheets, the further strengthening of their capital bases, and the conditions in the wholesale funding markets. Overall, I expect that the availability of bank credit to firms and households will gradually improve and will not impose constraints on the expansion of economic activity.

A second reason is that credit growth is not the only determinant of price developments. As economic activity is expected to progressively strengthen in the coming quarters, even if at a moderate and uneven pace, the tighter conditions in the product and labor markets are likely to exert upward pressure on prices. Moreover, other factors, such as commodity prices and potential indirect tax increases, also entail upside inflation risks. At the current juncture, the risks to price stability over the coming two years are broadly balanced, as the European Central Bank's Governing Council recently assessed. A key factor that should address concerns about possible deflation risks is that inflation expectations remain firmly anchored to the aim of keeping euro-area inflation close to, but below, 2 percent.

TIE: **Is it possible several years from now that sovereign debt bond yields remain consistently below the yields of high-grade corporate bond yields? Is this a new era for the global bond market? To what extent have the industrialized world governments lost long-term credibility in their management of public finances?**

Papademos: It is very unlikely and it is certainly undesirable that sovereign bond yields will be higher than the yields of high-grade corporate bonds. Such an outcome would imply that markets have lost confidence in the ability of governments to restore sound public finances and ensure fiscal sustainability. Regrettably, some governments of industrialized countries have lost or risk losing credibility in their management of public finances. Regaining or maintaining fiscal policy credibility and ensuring that government bond yields retain their status as "risk-free" rates of return are essential for sustained and robust economic growth.

TIE: **Over the last year, the Bank of England has purchased roughly 80 percent of the British government's debt. In the United States, the large banks, acting as the Fed's proxy, are borrowing from the Discount Window and purchasing huge amounts of Treasury and government agency securities. And, of course, the Bank of Japan began piling up Japanese government debt on its balance sheet beginning in the 1990s. To what extent will the European Central Bank follow the same path? Moreover, if the industrialized world central banks all become the primary purchasers of sovereign debt—the "purchasers of last resort," so to speak—would this situation represent an inflationary or contractionary phenomenon?**

Papademos: During the crisis, central banks have purchased government debt as a means of achieving their monetary and financial stability objectives in situations of extraordinary market stress. The aim of these central bank operations was not the monetization of government debt but the containment of risks to the financial system and the broader economy.

There is a need to foster labor market policies across the euro area that are compatible with the European Central Bank's monetary policy.

The European Central Bank started buying government securities only recently. As it was clearly stated when the Securities Markets Programme was introduced—and emphasized on numerous occasions thereafter—the purchase of securities in the secondary markets is aimed at improving their functioning, where it had become severely impaired as a result of exceptional circumstances, and at restoring the smooth transmission of monetary policy across the euro area. In assessing the nature and implications of these operations, two points are important. First, these operations are temporary and are being carried out in order to address the consequences of a crisis situation. They will be discontinued as soon as market functioning improves. Therefore, there is no risk that the central bank will become the primary buyer of sovereign debt. Second, the purchase of securities does not lead to an increase in central bank money and does not entail inflationary risks as the European Central Bank systematically withdraws, by liquidity-absorbing operations, the bank reserves created by the purchase of securities. Indeed, as a result of the phasing out of the various non-standard measures taken over the past year, the amount of liquidity in the euro area interbank money market declined by more than €250 billion between the beginning of May and the end of July 2010.

More generally and looking ahead, there is no risk that the central banks of industrialized countries will become the "sovereign debt purchasers of last resort" because they will be vigilant against the potential inflationary risks that such actions could entail in the long run. Central banks are committed to preserving price stability and I am convinced that this should and will remain their primary objective. ◆