

Policies on sovereign debt

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This paper seeks to convey four main messages.

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.

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Sovereign debt is the most pressing and difficult policy challenge confronting advanced economies. According to the OECD it will, in total, exceed 100% of their combined GDP in 2011, a level that has never before been reached in peacetime.

Debt is a legacy of the past and, somehow, it prevents us from thinking positively about the future. High levels of debt have a corrosive effect on the social fabric of our societies. Debt fuels anxiety and erodes confidence. Debt also amplifies existing concerns on fairness and income distribution. Political compromises on fiscal adjustments become more difficult to reach and, overall, the willingness to repay debts diminishes as the sums accumulate.

In this environment, the challenge is twofold. Politically, our societies must learn to live with debt while looking optimistically to the future and maintaining a sense of progress. Economically, advanced economies have to define a sustainable path for public debt, which keeps it under control while preserving growth and avoiding disruptive episodes of financial instability. Because there is no precedent, history can only give partial guidance. This paper presents a number of ideas, starting with basic analytics and moving to more debatable and controversial issues and reflections. All the views expressed here are, of course, personal.

1| THE FUNCTIONS OF SOVEREIGN DEBT

The primary function of sovereign debt is to help finance the Government. Public budgets do not always balance, and nor should they. It makes sense to let the budget fluctuate with the economic cycle as part of the so-called automatic stabiliser effect. This introduces a cyclical element into the dynamics of public debt, which ultimately cancels out. When the budget is structurally balanced, the nominal amount of debt does not change over the cycle and the debt/GDP ratio decreases over time. For the euro area, the structural balance rule is enshrined in the new Treaty. This Treaty provides an effective anchor for a steady reduction in debt/GDP ratios over the long run and represents a firm assurance for market participants as to the sustainability of euro area debt.

Debt may also exhibit an increasing trend beyond the cycle, as it has done over the last decade, with

most advanced countries running structural deficits. There may be good or bad reasons. Both on grounds of efficiency and fairness, it is justified to make future generations pay for the infrastructures, knowledge, and technologies they will inherit from current generations. However, it is not justified, as many countries have done, to postpone paying for current public consumption or build up claims on future output because health and pension commitments are unfunded.

A second function of sovereign debt is to serve as a store of value. Government bonds are backed by the power to tax and therefore, uniquely placed to park and transfer wealth from one period (or one generation) to another. They fulfill an essential function as the ultimate riskless asset. Also, the debt markets of advanced economies are the most liquid in the world and, for the short end of the curve, Treasury bills act as very close substitutes to money. Only the government bonds of advanced economies jointly possess these two characteristics of safety and liquidity.

Such safe and liquid assets are absolutely necessary in a modern economy. They serve as benchmarks and references for pricing and valuing financial instruments. All financial systems depend on the existence of a riskless asset as a pillar on which all asset pricing can be built, including the derivatives market. Without a risk-free rate, things are much more complicated.

Third, there is a very strong demand for such assets. They are used as collateral for private transactions between financial intermediaries. They serve as the primary support for monetary policy operations in many countries. In times of uncertainty and financial stress, they provide the ultimate safe haven. And, lastly, most foreign exchange reserves are held in the form of government bonds (or equivalent securities such as, in the United States, the so-called Government Sponsored Agencies securities).

From a financial stability perspective, the supply of government bonds has, therefore, deep implications, long recognised by the literature. Turner (2011) mentions the necessity of “official accommodation of private liquidity preference”, quoting Keynes’ recommendation that debt issuance “should accommodate the preferences of the public for different maturities”. Such preferences are shifting

and, therefore, the Government should be prepared to issue short-term, highly liquid paper in amounts sufficient to meet any private demand. Government bonds are the main, if not sole, source of “outside liquidity”, which is absolutely necessary if a shock to aggregate liquidity demand occurs (Tirole 2008). In the absence of an adequate supply, liquidity shortages may lead to disruptions in financial intermediation, a fall in asset prices and a decrease in effective demand for goods.

The supply of adequate liquidity instruments is also essential for the international monetary and financial system.

According to the «asset shortage» theory (Caballero, 2006), the world suffers from a relative scarcity of financial assets that are both liquid and risk-free. And there is a strong and permanent asymmetry in the ability of different countries to create and manufacture them. Global imbalances may be partially explained by the unique ability of some countries, essentially the United States, to provide a sufficient supply of such assets. Those countries act as magnets for capital inflows.

The search for safe “parking spaces” may lead to an unrestricted demand for assets whose value is perceived as protected, hence fueling bubbles and creating financial fragility. Accordingly, the financial crisis is interpreted as resulting from misguided attempts to manufacture such riskless assets through the process of securitisation.

If that view is correct, the world may be facing a dilemma in the future. On the one hand, economic uncertainty in advanced countries and excess savings in emerging economies are increasing the demand for safe and liquid assets. On the other, higher debt levels create doubts about the solvency of sovereigns in some advanced economies. Fiscal consolidation will further restrict the net supply of such assets. This is very reminiscent of the Triffin dilemma which affected the supply of dollars in the 1960s through the US balance of payment deficits. In our contemporary world, we face a Triffin dilemma on sovereign debt, as identified by Obstfeld (2011) regarding foreign exchange reserves: “How will the demand for reserves be satisfied if the richer countries actually succeed in the fiscal consolidation to which they currently aspire?”. To meet demand, Governments have to issue additional amounts of debt, but in so doing,

they undermine the riskless character which makes them an effective store of value. The latter part of this paper examines this paradox in more detail and offers some tentative solutions.

2| DEBT SUSTAINABILITY AND FINANCIAL STABILITY

With debt reaching unprecedented levels, questions about sustainability have dominated the policy debate. In the recent past, much attention has been focused on the situation in Greece and various other Euro area countries. But other countries are also engaged in vigorous internal discussions about their future fiscal prospects.

Any reader of economic or market literature cannot help but notice an almost universal tendency of analysts to look for clear, binary answers to the question of sustainability. Either debt is sustainable or it is not; and, in the latter case, the sooner recognition takes place (through default or restructuring) the better. Uncertainty almost never enters the picture.

Reality, of course, is more complex, and three points are worth making:

- Almost any debt is fully sustainable in certain “states of the world” and unsustainable in others. The standard approach for assessing sustainability compares the level of debt with the discounted value of primary surpluses over an infinite horizon. This calculation involves many parameters, all of them subject to a good degree of uncertainty.
- Projecting that uncertainty in a complex financial environment may give rise to different financial market dynamics, with possible multiple equilibria, some of them conducive to financial stability and sustainability, others more disruptive.
- Sustainability, therefore, is largely endogenous to the set of policies implemented by the authorities. Obviously, the credibility of fiscal consolidation is crucial when debt is high. Other policies, however, such as the legal treatment of debt and the willingness to repay will determine how the fundamentals of debt interact with financial markets to produce – or not – a sustainable and stable equilibrium.

According to standard analysis, debt dynamics can easily be described by a formula where the outstanding stock moves according to three parameters: the primary fiscal balance, the real growth rate and the real interest rate. This apparent simplicity can be misleading as it masks a very complex reality.

First, getting an idea of the underlying primary balance is not easy. In the past, tax elasticities have been seriously underestimated in many countries. The temporary boost to tax revenues during bubble periods has been treated as structural, opening the way to an equivalent increase in permanent expenditures. Contrary to public perceptions, the main fiscal slippages in advanced economies occurred prior to the crisis, not in reaction to it. Most countries entered the crisis with a structurally deteriorated fiscal balance, the true extent of which was only revealed when revenues collapsed. This is well documented by the IMF. Such mistakes can be avoided in the future by creating strong fiscal rules and sound institutional frameworks to obtain neutral assessments of the fiscal stance. These assessments should include implicit liabilities linked to future pension and health expenditure commitments.

Deeper questions must be asked when looking at the second parameter: potential growth. Debt dynamics are especially sensitive to growth assumptions. The impact of the crisis on future potential GDP and its evolution is highly uncertain. Public debate today is strongly influenced by the work of Reinhart and Rogoff (2008). Looking at a vast array of historical data, their study suggests that there may be non-linear effects of public debt on growth, with adverse output effects tending to rise as the debt/GDP ratio approaches the 100% threshold. This is a crucial contribution and it is rightly seen as a warning signal against “business as usual” fiscal policies. However, its utility in the future remains to be proven. To what extent should the historical references used serve as benchmarks for today’s policies? According to the IMF, stabilising debt-to-GDP ratios at their current level for the group of advanced economies would involve an improvement in their primary balance (cyclically adjusted) by approximately 6% of GDP.

The third parameter, interest rates, raises even more complex and interesting questions.

Interest paid on sovereign debt is determined by market forces. The crisis has raised many questions about the efficiency of financial markets. And those questions apply to government bond markets themselves. Risk premia were obviously too low for a long period before the crisis. Markets failed to discipline spendthrift governments.¹ Conversely, over-reaction does occur from time to time, with adverse implications for countries’ borrowing costs and debt dynamics.

There is a substantial endogeneity in the way markets assess sovereign risk. The perception of insolvency can create insolvency, because it leads to unsustainable interest rate levels. Ultimately, sustainability depends on beliefs and a debt crisis – whether private or public – is basically a discontinuous shift in beliefs.

The normal regime for a sovereign in advanced economies is when there is no credit risk attached to public debt. That was the situation prevailing for all advanced economies prior to the recent crisis. If and when sovereign debt is perceived as risky, then liquidity may dry up, adding further to risk premia and fueling increasing doubts about sustainability.

The conjunction of credit and liquidity risk creates powerful feedback loops and the possibility of multiple equilibria. In times of trouble, sovereigns, like financial institutions can be either illiquid, or insolvent, or both. In many cases, the distinction is blurred. When uncertainty is high, sovereigns face liquidity shortages, and they can only issue new debt at constantly higher interest rates. This, in turn, creates doubts about their ultimate solvency, triggering a negative spiral. In short, sovereign solvency is partly endogenous. Good fundamentals are an absolute necessity, but not always a sufficient condition. Liquidity spirals, when allowed to develop, can lock a country, just like a financial institution, into a negative equilibrium.

As Europe has experienced, two other powerful amplification mechanisms may be at work. First, “pure contagion” – when difficulties in one economy

¹ Awareness of this potential failure in market discipline was instrumental in the creation of the Growth and Stability Pact.

lead to a reassessment of risk for other sovereigns perceived as similar or belonging to the same asset class – and, second, a strong feedback loop between sovereign and banking risks leading at the extreme, to a total market freeze.

In this environment, financial and legal infrastructures matter enormously for debt sustainability. Should, for instance, the possibility of default be explicitly acknowledged when sovereign bonds are issued? Europe has struggled with this question before deciding to incorporate collective action clauses (CACs) in all future bond issuances. Such clauses have been commonplace for bonds issued under British law for many decades. So the change may be perceived as minor by bondholders. Explicitly providing for default or restructuring has many advantages: it reduces moral hazard and makes any default orderly. It creates a better environment to price credit risk. On the other hand, it changes the structure of incentives facing the sovereign and may make default more likely.

Those incentives matter. When the burden of debt is high, default appears as a tempting option. A cursory reading of basic sustainability formulae may seem to give it a rationale. It is also attractive politically. Making lenders pay for their past mistakes (and reckless lending) is appealing. And it is easy for taxpayers to forget (excluding non-resident holders of the debt) that their savings and pension accounts are loaded with those same government bonds whose value would be impaired in the event of restructuring or default.² The possible contagion and consequences for financial stability can also be easily overlooked.

Ultimately, when the fundamentals of sustainability become unclear and uncertain, the perceived willingness to pay becomes the key determinant of credit risk. The decision to introduce private sector involvement (PSI) for the treatment of sovereign debt in Europe was immediately followed by a broad widening of spreads. Casting doubt publicly about countries' willingness to pay carries a high price, especially in an environment where solvency doubts create liquidity squeezes and can ultimately develop into a "run" on sovereign debt (see Shirakawa in this issue of the *Financial Stability Review*).

3 | A NOTE ON SOVEREIGN RATINGS

Part of the negative feedback loop affecting sovereign debt is often attributed to ratings. The overall issue of ratings is well beyond the scope of this paper. Sovereign rating however, raises specific questions which may call for specific reforms.

Ratings are a solution to information failures and asymmetries which prevail on developed financial markets. To overcome those informational inefficiencies, investors use an agent whose function is to collect, process and disseminate information. By doing so, rating agencies contribute to market efficiency. They allow most investors to dispense with the efforts and costs of performing due diligence on their investments.

Ratings are not perfect. They oversimplify information by collapsing a whole set of variables into a single rating. They may also involve discontinuities and conflicts of interest. But these are difficulties we have to live with. There is no way to dispense with ratings in modern financial markets.

That is for private ratings. Sovereigns are different. There is no information asymmetry to deal with. Actually, it is quite the reverse: there are hundreds of institutions in the world which know more about public finances in Spain or the United Kingdom than rating agencies and have more resources to devote to examining those sovereigns. While rating agencies have an informational advantage with regard to corporates, they are at a disadvantage on sovereigns. This is, basically, why they lack legitimacy. The relative paucity of their resources makes them vulnerable to technical mistakes, undermines their credibility in economic assessment and creates suspicion as to their ultimate motivations.

An easy solution would be to use existing expertise to produce information. Central banks and governments are used to measuring consumer sentiment, inflation expectations and credit conditions. The ECB conducts a survey of professional forecasters which plays an important role in assessing the prospects for growth and inflation

² Ultimately government bonds are a claim by the society on itself, although with important inter-generational transfers.

All these surveys are based on the same intellectual process: the collection and processing of information from a large number of participants to produce a synthetic and forward looking assessment.

The same methodology could be transposed to the provision of credit ratings for the 30 or 40 major sovereigns in the world. Hence a broad selection of institutions could be asked to provide anonymous quantitative assessments which would then be aggregated, filtering out the outliers, with the results published on a regular basis. The sample of institutions would be very large and include both private market participants and public institutions (all of which currently generate their own assessments and publish them separately). In addition to the “central” rating, the probability distribution could be published and various measures (disagreements, doubts) could be extracted. The costs would be minimal.

4| DEBT, MONETARY POLICY AND FISCAL DOMINANCE

Over the last decades, all advanced (and most emerging) economies have adopted a monetary regime based on central bank independence with price stability as a central objective.

This regime relies on the ability of central banks to effectively control prices and inflation. More significantly, it relies on the perception that they will be able to do so in all circumstances. «Monetary dominance» implies that fiscal policy can always be adjusted to meet the government’s inter-temporal budget constraints, whatever action the central bank may have to take.

With moderate levels of debt, there is no threat to monetary dominance: the inter-temporal budget constraint can be satisfied in all possible states of the world. When public debt reaches high levels there is more uncertainty. First, high primary surpluses are needed, which may prove difficult or even impossible to achieve. Second, any monetary tightening, in the form of higher interest rates, will aggravate the debt service burden and make it less likely that the budget constraint will be met. At very high debt levels, there is no “state of world” where the budget constraint and the objective of price stability can be satisfied simultaneously.

This scenario has long been recognised in the literature. Two broad theories are available. The first, and universally accepted, is based on the «unpleasant monetary arithmetic» by Sargent and Wallace (1981): “When the public reaches its limit and is no longer willing to hold public debt, the government would have to resort to monetisation. The result, consistent with the quantity theory of money, is inflation”. (Cecchetti, 2010). The second, more controversial, is the Fiscal Theory of the Price Level (FTPL). It posits that, given the nominal debt outstanding, the price level must adjust so as to bring the real debt to a sustainable level (i.e. compatible with the budget constraint). How this is achieved, and through which mechanisms, is not perfectly clear and this is one reason, amongst others, why the theory remains highly contested.

It is not necessary to fully adhere to the analytics of FTPL to appreciate the central message common to the two approaches. Long run inconsistency between monetary and fiscal constraints will result in either inflation or sovereign default. So, if default is to be avoided, «fiscal dominance» of monetary policy becomes a real possibility. The existence of such a dilemma might be sufficient to trigger expectations of future inflation which in turn, could translate into higher inflation today.

Intuitively, such an outcome is more likely if the monetary regime is perceived to be weak. Expectations of inflation in advanced economies have remained remarkably stable and this is a testimony to the robustness of our current monetary regimes. This robustness, however, may be tested over the coming period. In all countries, central banks have been active, to various degrees, in buying significant amounts of government debt.

Analytically speaking, there are four reasons why central banks might want to purchase public bonds:

- To implement non-standard monetary policies in a Zero Lower Bound environment. Once policy rates have reached the zero level, bond purchases may contribute to further monetary stimulus by reducing risk premia and long-term interest rates.
- To compensate for a liquidity squeeze and acting as lender of last resort if markets become so dysfunctional that, for instance, the transmission mechanism of monetary policy is severely impaired. This could happen both in the public and private debt markets.

- To fight against deflation. This is a situation where private demand for goods is inhibited by expectations of further price decreases and where, inversely, demand for money may become infinite. In that case, financing public demand through deliberate money creation may appear as a solution (although there are doubts about its efficiency).

- Pure monetisation, i.e. fully succumbing to fiscal dominance and ensuring the solvency of the sovereign.

All these policy actions involve the same technical operation, i.e. the purchase of public bonds. But they have very different purposes and carry very different consequences. The outcome will ultimately depend on how economic agents interpret central banks' behaviour. Depending on the perceptions, non-standard policies based on large-scale purchases of public debt may appear as a temporary and necessary departure from normality or, on the contrary, signal a shift to a new longer-term monetary policy designed to accommodate high levels of public debt.

Central banks are unambiguous: all of them have reaffirmed their commitment to price stability, emphasising the temporary nature of their non-standard measures and they have all outlined exit strategies to be implemented when the time comes. Some of them have recently strengthened their framework and communication strategy by setting and announcing quantified inflation targets.

Sentiments and opinions expressed by market participants, analysts and economists are more diverse. Evidence suggests that confusion between the above-mentioned objectives is a real possibility.

Many would welcome central banks' active engagement in buying public debt as an insurance against default. Professor Sims puts the argument most elegantly in this issue of the FSR by arguing that (temporary) inflation provides the necessary flexibility to absorb exceptional shocks on national budgets. But this raises important time consistency issues. Once central banks have signaled that they are prepared to accept some dose of fiscal dominance, there is no guarantee that they will go back to their pre-crisis objectives regarding price stability. There is very little left to anchor inflation expectations in the long run. This is the essence of the time inconsistency problem. Flexibility may appear optimal in the short run, but has permanent costs in

the longer run: in this case, most likely, the appearance of an inflation bias. I do not believe that there is right now, in most of our countries, any choice to be made between inflation and default. Fiscal dominance is not a threat, provided credible consolidation occurs and no ambiguity appears on the willingness to pay. But suppose such a trade-off were to develop; then each policy option would need to be assessed by taking full account of all its cost and benefits. The costs of default, in terms of overall welfare, should be weighed against the costs of permanently higher inflation and the loss of central bank credibility.

A similar argument is frequently made with a different presentation. It goes as follows: central banks should act as "lenders of last resort to governments" in order to prevent or attenuate liquidity squeezes on sovereign bond markets. The insurance against default does not come, here, from tolerance of higher inflation, but from acceptance of unlimited liquidity provision to the government. According to this theory, only those governments which benefit from that liquidity insurance can be considered as "full sovereigns". Others, including those, in the euro area which do not control their central bank, are considered "sub sovereigns"; they run a higher risk of default and their debt should be treated with stricter prudential requirements.

This argument is flawed. It presupposes that there is no limit to the liquidity that a "full sovereign" can draw from its central bank. If there is a limit, of course, the full sovereign is no different from the sub-sovereign: both could default as a result of a temporary lack of liquidity. But if there is no limit, then the central bank has de facto accepted full fiscal dominance. It's only a matter of time before the markets realise this and inflation expectations start creeping up. Sub-sovereigns are sometimes defined as "having the power to tax but not to issue currency". That definition implies that the power to issue currency is seen permanently as a complement or a substitute to the power to tax. This is a different policy environment from the world we have been living in for several decades.

What is really at stake is the monetary regime. It would be dangerous, for central banks, when deciding on policy actions, to ignore the high debt environment in which they will operate over the next decade and the risk that their actions could be misinterpreted as acquiescing implicitly to a shift towards fiscal dominance.

5 | DEBT AND GLOBAL IMBALANCES

The international economic agenda is predicated today on one major objective: reducing current account imbalances, which are seen as a source of potential financial instability and a threat to future growth. This focus on current account imbalances may be misguided.

In the short run, a reduction in emerging countries' saving rates would push real interest rates higher, further complicating debt sustainability in advanced economies. That effect might well over-compensate any boost on global demand that would result from increased consumption and investment in surplus countries.

In the long run, the imbalances that count are imbalances *in stocks*. In the next decade, we will live in a world with numerous asymmetries. Two stand out. First in the area of financial development and, essentially, the ability to produce safe and risk-free assets. And second in public debt levels: 30% on average in emerging economies as compared to 100% in advanced countries. It turns out that those two asymmetries complement each other well. Provided they preserve their ability to manufacture safe assets for savers in emerging economies, advanced countries can find suitable paths to debt sustainability and growth. And emerging economies may find it convenient to park their wealth in safe assets in advanced economies.

The benefits of such arrangements could extend well beyond capital markets themselves. Many oil and commodity producers face an inter-temporal choice between extracting resources and keeping them on or under the ground. According to standard economic reasoning (the Hotelling rule), one important determinant is the return earned on financial assets, to be compared to the expected commodity price increase over the long run. Providing producers with safe stores of value would eliminate or reduce the possibility of large losses. It would make it less optimal to reduce the rate of extraction in periods of uncertainty and reduce the risk of durably lower supplies of oil and other commodities (Landau, 2009).

The long-run solution of course, is to eliminate first the asymmetries and second the stock imbalances. But it will take time. There is no real appetite in emerging economies for running high budget

deficits, and stabilising debt/GDP ratios in advanced countries already looks like a significant challenge. Financial development in EMEs would imply significant changes, starting with full capital account convertibility. Acceptance of new financial instruments denominated in emerging currencies will further depend on their liquidity, a process subject to delays and discontinuities, as network effects would come into play in an unpredictable fashion. In the interim period, countries may have to bear the constraints of financial opening without getting the benefits.

So, most likely, some imbalances in current accounts are here to stay as a permanent, even necessary, feature of the world economy. Policies should internalise that “state of the world”, instead of trying to change it, and they should try to make it sustainable and stable. Excess demand for safe assets will persist in the future. A major question, however, is how that demand can be met.

Credible fiscal consolidation in advanced economies is certainly a prerequisite, but only part of the solution. It would avoid “depreciating” existing debt and further shrinking the pool of available risk-free assets. But, by itself, it may not provide a sufficient supply to meet future needs. How can advanced economies fulfill that responsibility while preserving the soundness of their public finances, thus overcoming the Triffin dilemma? First, they should eliminate forever any doubt on their willingness to pay. This has deep implications on the legal structure of public debt, as well as on the workings of the political process. Both the introduction of CACs in Europe and the periodic uncertainties on raising the debt ceiling in the United States may have created additional uncertainty which should be removed. Action is needed to strengthen the legal and political infrastructures.

Simultaneously, there is room for meaningful and positive financial innovation to create new classes of risk-free assets. This may be a controversial statement to make right now: one of the causes of the financial crisis may have been misguided financial innovation aiming, precisely, at manufacturing, through complex securitisation, assets that appeared to possess risk-free characteristics, but that carried hidden tail risks, which materialised with lethal effects. This was, however, a disorderly process that was poorly supervised and inadequately monitored and whose development was distorted by skewed incentives. A different approach, promoted by public authorities themselves,

in full transparency, would be very different and use financial innovation for the public good.

Many avenues could be explored. Two could be particularly productive:

First, instruments based on real – physical or productive – assets (including land) and partially replicating their risk/return profiles. If they do not transfer ownership of those assets, they could help circumvent the political obstacles attached potentially to a substantial expansion in foreign direct investment flows from emerging to developed economies.

Second, instruments based on a diversified portfolio of sovereign risk. Most current thinking revolves around the idea of pooling and sharing sovereign risk (through Eurobonds, for example), a step which would create both strong solidarity but impose a high degree of common coordination and discipline on national fiscal policies. Political obstacles, however, are enormous and may prevent the emergence of such instruments for a very long period.

The same objective could be achieved, without such political constraints, by seeking safety and liquidity not in the sharing of risk but in the structure of the instrument itself. At the European level, one proposal is to create European safe bonds (or “ESBies”) obtained by extracting a senior tranche from a diversified portfolio of Government bonds. Properly implemented, and closely managed and supervised, those instruments could provide a much needed supply of safe euro-denominated assets (as witnessed by the appetite of non-euro investors for European Financial Stability Facility – EFSF – issuances).

6 | CONCLUSION

This paper seeks to convey four main messages.

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.

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