THE CRISIS OF EUROZONE-IMPLICATIONS, DIMENSIONS, INDIAN ASPECT AND REFORM PROPOSAL

Hasnan Baber[1] and Adil Zahoor[2]

Assistant Professor, Islamic University of Science and Technology, J&K, India
Email: [1]baber.mba@gmail.com, [2]adylzahoor@gmail.com

ABSTRACT

The sovereign debt problems in the peripheral economies of the euro zone has started to pose a serious threat to the main economies of the Europe and perhaps to the future of the 'euro' itself. Such a situation is a far cry from the optimism and grand vision that marked its launch. This paper is an attempt to understand the implications of the ongoing euro zone crisis and the factors that make it somewhat unique as the contradictions of a monetary union without a fiscal union are coming to fore. The paper shows that the crisis is not merely related to sovereign debt and bank financials but also rooted in the real economy with structural problems. The manner in which the crisis is dealt is likely to be of far reaching significance to Europe and to the rest of the world including India. The stage seems set for a change in the way in which the euro zone will need to manage its monetary, fiscal and financial system.

Keywords: Sovereign debt crisis, Euro Zone, Euro Currency, European Central Bank, Bailouts

INTRODUCTION

The Euro Zone crisis is an ongoing financial crisis that has made it difficult or impossible for some countries in the euro area to re-finance their government debt without the assistance of third parties. From late 2009, fears of a debt crisis developed among investors as a result of the rising government debt levels around the world together with a wave of downgrading of government debt in some European States. Concerns intensified in early 2010 and thereafter, leading Europe's finance ministers on 9May 2010 to approve a rescue package worth Euro 750 billion aimed at ensuring financial stability across Europe by creating the European Financial Stability Facility (EFSF).

Over the last two years, the euro zone has been going through an agonizing debate over the handling of its own home grown crisis, now the euro zone crisis. Starting from Greece, Ireland, Portugal, Spain and more recently Italy, these euro zone economies have witnessed a downgrade of the rating of their sovereign debt, fears of default and a dramatic rise in borrowing costs. These developments threaten other Euro zone economies and even the future of the Euro.

Such a situation is a far cry from the optimism and grand vision that marked the launch of the Euro in 1999 and the *relatively* smooth passage it enjoyed thereafter. While the Euro zone may be forced to do what it takes, it is unlikely that the situation will soon return to business as usual on its own. Yet, this crisis is not a currency crisis in a classic sense. Rather, it is about managing economies in a currency zone and the economic and political tensions that arise from the fact that its constituents are moving at varying speeds, have dramatically different fiscal capacities and debt profiles but their feet are tied together with a single currency.

Given the large economic weight of the euro zone in the globe, and regularity with which the crisis is spreading from one euro zone economy to the next, the stage for palliatives is over. The manner, in which the euro zone crisis is dealt this point onwards, is likely to be of far reaching significance to the world. This paper shows that the crisis is not merely of sovereign debt and bank financials but also rooted in the real economy with structural problems. The stage is set for a change in the manner in which the euro zone will have to manage its monetary, fiscal and financial system.

LITERATURE REVIEW

The current Eurozone crisis has a number of straightforward causes. Several Eurozone countries – Greece, Ireland and Portugal – have come under severe financial market pressure, featuring high interest rates on government bonds and difficulty in servicing their national debt. They suffer from a lack of adequate fiscal support (Challenge (1)). The Eurozone rescue package, supported by Eurozone governments and the IMF, provides some support for heavily indebted countries, but financial markets perceive this support to be insufficient. However, some Eurozone governments – among which Germany figures prominently– are reluctant to extend the rescue package sufficiently to cover all conceivable national solvency risks, since they are uncertain whether their contributions will be repaid, indicating a lack of confidence in the Eurozone's fiscal responsibility (Challenge (2)).

This also explains their reluctance to create Eurobonds. Such Eurobonds will inevitably allow fiscally weak states to benefit the superior credit ratings of the fiscally strong states, particularly Germany. The strong states, in turn, would face higher interest rates. This clearly implies a fiscal transfer from the strong to the weak states – though perhaps one that is not sufficiently transparent to attract much voter attention. Of course, bond purchases by the

European Financial Stability Facility (EFSF, the main emergence lending facility in the Eurozone) or the European Central Bank (ECB) may also lead to fiscal transfers, if the bond issuers should have difficulty repaying their debts.

Various politicians and other commentators have suggested that Eurobonds could become acceptable to fiscally strong countries, such as Germany, provided that there was binding fiscal oversight of all EU countries at the European level, perhaps conducted by the

EU Commission. This would institutionalize fiscal responsibility at the pan-European level, thereby reducing the likelihood of national solvency crises in the future and increasing the likelihood that inter country loans will be repaid. However, it is extremely unlikely that EU governments would consent to such a reduction of fiscal autonomy (Challenge (3)).

Meanwhile, the countries supported by the Eurozone rescue package are required to implement large-scale government expenditure reductions and tax rate increases in order to reduce their deficits. The problem with this strategy is that it worsens the recessions of these countries, and deeper recessions mean lower tax revenues and higher government transfers to the unemployed and other entitlement recipients. Thus the contractionary fiscal policy stance generates more national debt, making it even more difficult for these countries to overcome their solvency crisis. In short, countries in greatest need of counter-cyclical fiscalpolicy are prevented from using it (Challenge (4)).

The present crisis is likely to persist, or at least continue simmering under the surface, as long as the Eurozone has (i) heavily indebted states with potential solvency problems, which are (ii) not certain of receiving adequate outside support to pay their debts, (iii) forced to implement sharply contractionary fiscal policies, thereby generating further national debt, and (iv) unwilling to yield their fiscal sovereignty to the creditor countries. This is the reason why a solution to the Eurozone crisis requires credible enforcement of fiscal responsibility; adequate fiscal support; the opportunity to engage in counter-cyclical fiscal policy; and the maintenance of states' fiscal autonomy.

FINDING AND RESULTS

Main Causes of Euro Zone Crisis

The European sovereign debt crisis has resulted from a combination of complex factors, including the globalization of finance; easy credit conditions during the 2002–2008 period that encouraged high-risk lending and borrowing practices; international trade imbalances; real estate bubble that have since burst; slow economic growth in2008 and thereafter; fiscal policy choices related to government revenues and expenses, particularly high entitlement spending, self-Welfare state; and approaches used by nations to bailout troubled banking industries and private bondholders, assuming private debt burdens or socializing losses. One narrative describing the causes of the crisis begins with the significant increase in savings available for investment during the 2000–2007periods when the global pool of fixed income securities increased from approximately$36 trillion in 2000 to $70 trillion by 2007. This "Giant Pool of Money" increased as savings from high-growth developing nations entered global capital markets. Investors searching for higher yields than those offered by U.S. Treasury bonds sought alternatives globally.

Rising Government Debt Levels

In 1992, members of the European Union signed the Maastricht Treaty, under which they pledged to limit their deficit financing and debt levels. However, a number of EU member states, including Greece and Italy, were able to circumvent these rules and mask their deficit and debt levels through the use of complex currency and credit derivatives structures. The structures were designed by prominent U.S. investment banks, who received substantial fees in return for their services and who took on little credit risk themselves thanks to special legal protection for derivatives counterparties.

Trade Imbalances

Commentators such as Financial Times journalist Martin Wolf have asserted that the root of the crisis was growing Trade imbalances. He notes in the run-up to the crisis, from 1999 to 2007, Germany had a considerably better public debt and fiscal deficit relative to GDP than the most affected euro zone members. In the same period, these countries (Portugal, Ireland, Italy and Spain) had far worse balance of payments positions. Whereas German trade surpluses increased as a percentage of GDP after1999, the deficits of Italy, France and Spain all worsened.

Monetary Policy Inflexibility

Since membership of the euro zone establishes able to "Print Money" in order to pay creditors and ease their risk of default. (Such an option is not available to a state such as France.) By "printing money" a country's currency is devalued relative to its (euro zone) trading partners, making its exports cheaper, in principle leading to an improving balance of trade, increased GDP and higher tax revenues in nominal terms. In the reverse direction moreover, assets held in a currency which has devalued suffer losses on the part of those holding them. For example by the end of 2011, following a 25 percent fall in the rate of exchange and 5 percent rise in inflation, euro zone investors in Sterling, locked into euro exchanges rates, had suffered an approximate 30 percent cut in the repayment value of this debt.

Loss of Confidence

Sovereign CDS prices of selected European countries (2010–2011). The left axis is in basis points; a level of 1,000 means it costs $1 million to protect $10 million of debt for five years. Prior to development of the crisis it was assumed by both regulators and banks that sovereign debt from the euro zone was safe. Banks had substantial holdings of bonds from weaker economies such as Greece which offered a small premium and seemingly were equally sound.

Rating Agency Views

On December 5, 2011 S&P placed its long-term sovereign ratings on 15 members of the euro zone on "CreditWatch" with negative implications; S&P wrote this was due to "systemic stresses from five interrelated factors:

1. Tightening credit conditions across the euro zone;
2. Markedly higher risk premiums on a growing number of euro zone sovereigns including some that are currently rated 'AAA';
3. Continuing disagreements among European policy makers on how to tackle the immediate market confidence crisis and, longer term, how to ensure greater economic, financial, and fiscal convergence among euro zone members;
4. In the first few weeks of 2010, there was renewed anxiety about excessive national debt. 5) Frightened investors demanded ever higher interest rates from several governments with higher debt levels, deficits and current account deficits.

Greece Economy

In the early mid-2000s, Greece's economy was one of the fastest growing in the euro zone and the government took advantage of it by running a large structural deficit, partly due to high defence spending amid historical enmity to turkey. As the world economy cooled in the late 2000s, Greece was hit especially hard because its main industries — shipping and tourism— were especially sensitive to changes in the business cycle. As a result, the country's debt began to increase rapidly. On 23 April 2010, the Greek government requested an initial loan of €45 billion from the EU and International Monetary Fund (IMF), to cover its financial needs for the remaining part of 2010. A few days later Standard & Poor's slashed Greece's sovereign debt rating to BB+ or "junk" status amid fears of default , in which case investors were liable to lose 30–50% of their money. Stock markets worldwide and the Euro currency declined in response to this announcement On 1 May 2010, the Greek government announced a series of security measures to secure a three year €110 billion loan. This was met with great anger by the Greek public, leading to massive protest, riots and social unrest throughout Greece. The Troika (EU, ECB and IMF), offered Greece a second bailout loan worth €130 billion in October 2011, but with the activation being conditional on implementation of further austerity measures and a debt restructure agreement. A bit surprisingly, the Greek Prime Minister George Papandreou first answered that call, by announcing a December2011referndum on the new bailout plan, but had to back down amidst strong pressure from EU partners, who threatened to withhold an overdue €6 billion loan payment that Greece needed by mid-December. On 10 November 2011 Papandreou instead opted to resign, following an agreement with the New Democracy party and the Popular Orthodox Rally, to appoint non-MP technocrat Lucas Papa demos as new prime minister of an interim national union government, with responsibility for implementing the needed

The Proposal

Each Eurozone government that wishes to have access to the Eurozone rescue package should be required to fulfill two requirements:

Formulate a fiscal rule: This rule must specify (1) the country's long-run debt ratio (the ratio of national debt to national product), (2) the fiscal convergence rate (the average rate at which this debt ratio is to be approached and (3) the degree of fiscal counter-cyclicality (how much fiscal stimulus the economy should receive in a recession and, correspondingly, how much fiscal contraction it should get in a boom).

Create a fiscal authority or constitutional amendment to implement the rule: Since the fiscal rule allows for counter-cyclical fiscal policy, it requires estimation of the country's business cycle. The fiscal authority (which we shall call the Debt Commission) would comprise independent technical experts who

(1) Estimate the country's business cycle and

(2) Determine the government's deficit or surplus that is consistent with the fiscal rule. The

Debt Commission would have veto power over the government's fiscal decisions, tonsure that the government's fiscal rule is followed. Alternatively, the fiscal rule could be implemented through a constitutional amendment committing governments to adhere to this rule. Once again, the fiscal rule would require estimation of the business cycle, to be performed by a Debt Commission that is independent of the government.

Note that the government is the author of the fiscal rule. It thereby retains fiscal sovereignty.

The Debt Commission simply implements the rule. Since the Commission has the power to do so, it ensures that the government keeps its fiscal promises.

Furthermore, observe that the fiscal rule is not equivalent to a balanced-budget amendment, such as Germany's prospective "debt brake" (Schuldenbremse). Balanced-budget amendments do not require interpretation, since they generally require that government

At the crisis prevention stage the rationale for EU coordination is also straightforward in view of the high degree of financial and economic integration. Regulatory reform geared to crisis prevention, if not coordinated, can lead to regulatory arbitrage affecting location choices of institutions and may change the direction of international capital flows. Moreover, with many financial institutions operating cross border there is a clear case for exchange of information and burden sharing in case of defaults. The ongoing establishment of a new EU supervisory system will continue to help prevent future financial crises. The experience with the crisis underlines also the powerful rationale for stronger multilateral surveillance of economic policies within the EU. As regards the Central and Eastern European economies, Member States need to resist the emergence of imbalances and foster an efficient allocation of foreign capital.

Expenditures must equal government revenues, aside from cyclical swings resulting from the government's automatic stabilizers (operating through the tax and transfer system). However, balanced-budget amendments have two unfavorable effects: (i) they do not permit the government to fight extraordinary recessions with extraordinary fiscal stimuli (as happened worldwide in the aftermath of the financial crisis of 2008–09) and (ii) they imply that the long run debt ratio (the ratio of national debt to national product) gradually trends downwards toward zero, since the national debt remains constant whereas national product tends to grow. Shrinking debt ratios can be harmful to long-term growth (since they don't permit governments to provide more public goods as the economy expands). Countries require their long-run debt ratios to be constant, not declining.1

The above-mentioned fiscal rule avoids both of the above disadvantages, since it permits counter-cyclical fiscal policy in excess of the government's automatic stabilizers and specifies a constant long-run debt ratio.

The government is able to revise its fiscal rule whenever it deems appropriate. The only constraint on its fiscal power is its agreed commitment to the debt provision of the EU's

Stability and Growth Pact, which specifies that national debt should not exceed 60 percent of GDP in the long run.

1 A balanced-budget amendment has further undesirable consequences that much of the public and many policy-makers seem unaware of, namely, (i) the faster the economy grows, the faster the debt ratio must decline and (ii) if the economy shrinks, then the debt ratio can rise.

The Debt Commission must be completely independent of the government. Its estimates of the business cycle and calculations of permissible deficits or surpluses must be free of any government interference.

If this proposal were implemented, it would have the following implications. First, the fiscal rule would guarantee that a country's debts don't grow faster than its GDP. If the debt ratio (ratio of national debt to GDP) is set sufficiently low (such as the 60 percent specified by the Stability and Growth Pact), this would generally reassure financial markets that the country does not have solvency problems.

In theory, it is impossible to specify unambiguously what a country's socially desirable debt ratio should be. Clearly, it depends on various factors, such as whether the government's debts finance investment (in infrastructure, physical capital or human capital) or consumption (everything else) and who holds the debt. (The greater the share of debt used for investment purposes and the smaller the share of foreigners holding the debt, the larger is the social desirable debt ratio.) In practice, however, fiscal discipline requires adherence to simple, transparent criteria, and a country's debt ratio is such a criterion.

Second, since the Commission is independent of the government, it would reliably determine the deficits and surpluses that lead to this long-run debt ratio. The Commission would have no incentive to cheat, as the Greek government did.

Of course the Debt Commission may make mistakes in estimating the country's business cycle. No doubt: business cycle estimation is always subject to error. But at least the Commission's errors won't be politically motivated. This is crucial, since it is only the politically motivated errors that drive the debt ratio systematically upwards. The Commission's mistakes, by contrast, will be random – over the long-run, over-estimates will match under-estimates, leading to something approaching the specified debt ratio.

Third, since the Debt Commission has the power to set the government's deficits and surpluses, the commitment to sustain the country's solvency is credible. Thus financial markets would be assured that the government will adhere to its fiscal plan. Consequently, highly indebted countries that adopt the fiscal rule and fiscal authority will experience reductions in the interest rate on the national debt.

Fourth, the fiscal rule permits a country to stimulate the economy through fiscal policy during a recession. Thus we are not in danger of forgetting the lesson learnt in the Great Depression, namely, that it is folly for the government to reduce its expenditures and increase taxes in a recession-plagued economy. The reason is that these measures make the recession worse, leading to rises in unemployment benefits and reductions in tax receipts, thereby intensifying the recession.

Fifth, since each Eurozone government retains sovereignty over its fiscal policy, there would be no need to negotiate conditions under which member states cede authority over their fiscal policy to supra-national European entities. As noted, such negotiations are likely to elicit strong resistance from national governments, create tensions within the European Union and raise voter's concerns about a "democratic deficit" within the EU.

Sixth, since each country would ensure that its own financial affairs were in order over the long run, it would become easy to agree on a massive expansion of the Eurozone rescue package. The reason, of course, is that fiscally strong governments would be prepared to support their fiscally weak counterparts, since they would be assured that their loans will be repaid. Worries about the possibility of large, new interstate transfers would disappear.

Finally, voters would become empowered to determine their fiscal future. Under the prevailing arrangements, governments make their decisions on expenditures and taxes on a year-by-year basis. This makes them vulnerable to a "deficit bias". During recessions, governments generally require expansionary fiscal policy to reduce unemployment and promote production activity, but during booms they often face insuperable political pressures to spend too much. When tax receipts are surging, there is an irresistible temptation to spend them on all sorts of good causes and to buy the allegiance of all sorts of interest groups. On this account, the debt ratio has trended upward since the 1970s in most OECD countries. By contrast, when governments are required to formulate fiscal rules, their budget deficits during recessions are automatically compensated by surpluses in booms.

Though fiscal authorities have not been created thus far, there is a substantial body of evidence that fiscal councils (with the power to advise the government, but not dictate its budgetary decisions) often improve the fiscal performance of their governments.2 They have tended to be less effective when they were not deemed to be independent of political influence and when they had little influence on the budgetary process. These findings suggest that a fiscal authority, which is both independent of the government and can constrain the government's budgetary

Extensions

The proposed fiscal rule can be refined to (i) distinguish between government consumption and investment expenditures and (ii) distinguish between domestically-held and foreign-held public debt.

Government Investment versus Government Consumption

There is a case for treating debts that finance government investment (expenditures on physical capital, such as infrastructure, and on human capital, such as education and training) differently from debts that finance government consumption (all other government expenditures). The reason is that government investment generally enhances the productive potential of the economy and thus generates more national income in the future. This extra national income, in turn, will generate more tax revenues, which will reduce the future national debt. Naturally, government consumption does not have this effect.

To take this consideration into account, the long-run objective of the proposed fiscal rule could be amended as follows. Instead of targeting the government budget deficit/surplus at a long-run debt ratio, the fiscal rule could specify that the budget deficit/surplus should be targeted at a specific present value of the national debt. Then the fiscal rule would allow more current debt to be accumulated for financing government investment than for financing government consumption. The greater the rate of return on the government investment, the more current debt could be accumulated. If current government investment generated a debt that was exactly equal to the present value of the additional future tax revenues, then this government investment would not be considered under the fiscal rule.

Domestically-held versus Foreign-held Debt

The proposed fiscal rule implicitly makes no distinction between domestically-held and foreign-held public debt. It could be argued that this distinction should be made, since domestically-held public debt often tends to be less substitutable for other financial assets than foreign-held public debt is, and thus domestically-held debt is less vulnerable to financial market swings that could jeopardize a country's solvency.

If this distinction can be specified empirically, then the fiscal rule could treat domestically held public debt more leniently than foreign-held debt.

The well-known "golden rule" – whereby, over the cycle, the government can borrow only to invest and not to fund current consumption – is a simplistic version of this principle. It is simplistic, because it makes the implicit assumption that all government investment expenditure leads to additional tax revenues that are sufficient to finance the investment. Obviously, this assumption is not necessarily justified.

Caveat

It is important to emphasize that these extensions are difficult, if not impossible, to implementing practice. The reasons are clear: the rates of return on government investment and the substitutability of domestically-held versus foreign-held public debt relative to other financial assets are notoriously difficult to predict. They are thus particularly prone to become subject to political manipulation.

Other Proposals for Dealing with the Eurozone Crisis

The proposal above meets the four challenges summarized in the introduction of this paper. It ensures fiscal responsibility, since the fiscal rule is credibly enforced. It preserves the fiscal autonomy of member states, since each government formulates its own fiscal rule. It establishes the conditions necessary for the provision of adequate support for debtor countries, since loans (through the ECB and EFSF) would be unproblematic for creditor countries, given the credible assurance that the loans will be repaid. The existing reluctance to issue Eurobonds may also evaporate under these conditions.

The merits of other prominent proposals should also be assessed with regard to these four challenges.

- The haircut strategy: Restructure the debts of the crisis countries, such as Greece and Ireland, forcing the bondholders to accept a haircut on their interest and possibly principal. However if this strategy is implemented during a solvency crisis, it immediately raises interest rates on government bonds (making it even more difficult to finance the national debt) and, even more importantly, increases the risk of financial contagion (as creditors of other countries begin to fear the possibility of a future haircut as well). On this account, the haircut strategy runs afoul of Challenges (1) and (2), since it makes it more difficult for creditor countries to provide adequate support and for debtor countries to demonstrate fiscal responsibility.
- Issue Eurobonds, so that the heavily indebted countries can benefit from the resulting low interest rates. This strategy fails to meet Challenge (2) since it reduces governments' incentives to pursue fiscal responsibility.
- The fining strategy: Fine the fiscally irresponsible countries, to discourage them from accumulating excessive national debt. This policy suffers from a credibility problem: a country that has difficulty paying its debts cannot be credibly required to increase its debts through the addition of fines. The policy is analogous to the following novel type of fire insurance: when a fire breaks out in your house, the fire department comes and plants another fire.
- This may well encourage you to take extra fire precautions, but it is not helpful once the fire has started. The policy thus interferes with all four challenges: fiscal support, fiscal responsibility, fiscal autonomy and counter-cyclical fiscal policy.
- The Euro exclusion and default strategy: Exclude the excessively indebted countries from the Eurozone and allow them to default. In addition to creating substantial economic hardship in the affected countries, this strategy would also raise the risk of financial contagion, since bondholders in other Eurozone countries then perceive increased default risk. Financial contagion is likely to be accompanied by the collapse of banking systems, as people and enterprises liquidate their accounts in expectation of devaluation. Thus this strategy fails to meet Challenges (1) and (4) – fiscal support and counter-cyclical fiscal policy.
- Moving towards Eurozone fiscal union: Set minimum requirements for national fiscal frameworks, conduct in-depth country analyses scoreboards for economic and

financial indicators, and make fiscal recommendations when there are macroeconomic imbalances or competitiveness problems. This strategy does not meet the challenge of fiscal autonomy. On this account, it is unlikely that the Eurozone member states would heed such recommendations

Germany's Schuldenbremse (constitutional provision of a "debt brake"), which is an approximation of a balanced-budget law, for the other Eurozone countries.5

As noted, this strategy has two disadvantages. In the short run, it may prevent the use of counter-cyclical fiscal policy beyond the operation of the automatic stabilizers of the tax and transfer system. (If the debt brake is suspended in severe recessions, the credibility of the policy may become undermined, as happened to the debt provisions of the Stability and Growth Pact). In the long run, the strategy leads to continually declining debt ratios (even once the target debt ratio of 60 percent has been reached), thereby preventing governments from providing more public goods as the economy grows.

Impact on Indian Economy

The impact of this recent global instability on India has been enormous. India is a structurally current account deficit economy. This deficit is, in turn, financed by capital inflows, which over the past several years, had been large and stable enough to more.

In the absence of extreme circumstances, Germany's constitutionally binding balanced-budget law limits the size of new debt to 0.35 percent of GNP from 2016 onwards. Than offset the current account deficit. For a few months during the 2008-09 financial crises, the position was reversed and, when that happened, the Rupee behaved much like it did over the past several weeks. Between July 2008 and February 2009, the Rupee depreciated by nearly 17 per cent. Essentially, when capital stops coming in, the current account drives the exchange rate and, naturally, the pressure is to depreciate in the face of the deficit. With the kind of volatility we have seen in global capital flows over this period, virtually all EME currencies faced pressure to depreciate. However, the eventual magnitude of change reflected differences between countries in current account conditions as well as policy responses. For the past few years, the exchange rate regimen India has been what might be best described as a "bounded float". There are virtually no restrictions on Foreign Direct Investment (FDI), except for limits on specific sectors, and portfolio investment in equities. However, there are restrictions on debt inflows, driven by considerations of external stability. These limits relate to quantity, tenor and pricing. Short-term debt is the least preferred, because it is seen as most vulnerable to sudden reversals, while long-term debt, despite risk concerns, is seen as contributing to the resource flow into infrastructure, so is viewed more favorably.

These controls on debt might be viewed as "structural" or "strategic" capital controls; they are altered relatively infrequently in response to changing macroeconomic conditions and not with a view to impacting the daily movement of the exchange rate.

CONCLUDIND REMARKS

A country's solvency depends on two things: ability to pay and willingness to pay. Every developed country is able to repay its debts. That includes Greece. If the Greek government were to sell its assets, significantly increase the tax base and raise taxes more, the Greek national debt could easily be brought down to 60 percent of GDP, as required by the Stability and Growth Pact. The problem is that the current or future Greek governments may be unwilling to repay its debts.

In this respect, governments differ from individuals. People have to repay their debts, as long as they are able. If they refuse, the courts can force them to do so. However, you usually can't force a country to repay its debts without risking war. The assets of every developed country are sufficient to dwarf the size of its national debt. The government may be unwilling to use the assets for this purpose, for fear of losing office.

This implies that state solvency depends not merely on the solvency indicators that usually receive attention – competitiveness, growth rates, breadth of tax base, and so on – but also on the effectiveness and transparency of the political process whereby government budgetary problems are resolved. The proposal above is helpful in this regard, since it provides an institutional mechanism for ensuring willingness to pay.

Finally, the proposal represents a way of improving the functioning of democratic systems with regard to national debt. As noted, the prevailing fiscal systems are prone to deficit bias, since governments have insufficient incentives to run large budget surpluses during booms.

Furthermore, fiscal policy is often pro-cyclical (stimulating the economy in booms and contracting it in recessions), partly because of governments' short-term responses to budgetary pressures. There is widespread agreement that neither the deficit bias nor the fiscal procyclicality is in the public interest. But since governments are currently unable to commit themselves credibly to longer-term fiscal plans, voters are unable to induce their elected representatives to take the public interest into better account.

The proposal creates a credible commitment device to establish discipline. It thereby prevents deficit bias and enables governments to stabilize their economies through countercyclical fiscal policy. Governments' capacity to exercise fiscal responsibility depends on the task they are given. When their task is the short-run determination of government expenditures and revenues, reflecting an inability to make long-term commitments, the result is often a tendency for the national debt ratio to trend upwards. By contrast, no government – when given the task of formulating a fiscal rule – would formulate one that allows the debt ratio to explode with the passage of time. Instead, the government would set a constant debt ratio and thereby become committed to fiscal responsibility.

Indian aspect

First, in dealing with global turbulence and its short-term impact on India, we need to balance between the risk of a rupee spiral and that of a loss of confidence. Our capital account management framework gives us the capacity to do this and we will continue to use that capacity as appropriate. We have to recognize that volatility may be with us for a while and we have to deal with it. However, if the risk of a spiral escalates, reflected in sharp movements in the exchange rate, we will take swift action as and when necessary.

Second, domestic liquidity may be showing signs of stress. Here again, we have the instruments and the willingness to use them, in the context of our distinction between liquidity management and monetary policy.

Third, while there are many challenges to managing the growth-inflation dynamics, both external and domestic, they are manageable. Moderating growth will help ease inflationary pressures, which in turn will help growth stabilize. Of course, accelerating growth over the

ISSN – 2320-0073 Volume II, September'13

longer term without provoking inflation requires many structural changes, on which the policy establishment must put the highest priority.

Fourth, the crisis highlighted the economic interdependence of the EU, while also underscoring the lack of political integration needed to provide a coordinated fiscal and monetary response. Finally, the euro zone needs "the mother of all firewalls" if it is to protect the EU's single currency from debt contagion, the

Organization for Economic Co-operation and Development (OECD) has warned**.**

REFERENCE

1. Adalid, R. and C. Detken (2007), 'Liquidity shocksand asset price boom/bust cycles', ECB WorkingPapers 732
2. Ahrend, R., B. Cournède and R. Price (2008), Coordinating role in ensuring anorderly crisis resolution Bank of Greece (various years) Annual Report. Athens
3. Bank of Spain (2009) Annual Report 2008. Madrid: Banco de España.Available at www.bde.es.
4. Central Bank of Ireland (2010) "The Irish Banking Crisis: Regulatory and Financial
5. Stability Policy, 2003–08.
6. Eiglsperger, M., and Haine, W. (2009) "EU Housing Statistics" IFC Bulletin No.31.
7. Plagnol, V. (2010) "European Bond Markets in Financial Crisis."