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The International Policy Response to the Post-Crisis Rise in Sovereign Debt - A trade union critique

Discussion paper
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"Public deficits and debt […] have ballooned in the last three years for one simple reason – the big banks at the heart of our financial system blew themselves up. […] No one forced the banks to take on so much risk."
Simon Johnson, January 2011

"There is a meaningful risk that the eventual cost of the [banking] *recapitalisation effort could considerably exceed the government's current projections."*
Moody's explaining the downgrading of Spain's credit rating, March 2011

"The central thrust of the current proposals is to exert downward pressure on wages; and to interfere in collective bargaining. This austerity is deflationary, unfair, and socially regressive. […] Lest we forget, it was not pay – and labour markets - which caused this crisis."
Letter of John Monks (ETUC) to the EU Heads of States, March 2011

INTRODUCTION

1. In the second quarter of 2010 the policy consensus at the OECD, IMF, the European Commission and in many G20 Finance Ministries shifted from support for the global demand in the wake of the recession to giving priority to near term reductions in fiscal deficits, primarily through major reductions in public expenditure. This shift was not brought about by changing forecasts in private sector economic activity in most of the OECD area, but rather by a panicked reaction to the bond market jettisoning of Greek sovereign debt and the fear of contagion to the whole of the Eurozone.

2. This shift in policy was based on a rudimentary assessment of the causes and dynamics of the crisis. The priority became a reduction in sovereign debt through unprecedented budget austerity programmes, the costs of which will be borne almost entirely by workers and their families: cuts in public services and in social protection, regressive tax reforms, and downward wage flexibility. At the same time, the much needed re-regulation and downsizing of the financial sector, which triggered the crisis in the first place, was either scaled back or was postponed to "better days" which given the current economic prospects might take many years to materialise.

3. The risk is not only that the shift in policy response will be ineffective in restoring growth; it will actually lay the ground for the next crisis. The crisis was triggered by the behaviour of lightly regulated and globalised financial markets, which dominated the real economy rather than being its servants; but the fundamental cause was the unsustainable model of growth of the 1990s and 2000s which fuelled rising inequalities and excessive leveraging. The current OECD-IMF "consensus" will simply replicate those trends; it will create further inequalities.

4. From a trade union perspective the OECD-IMF police response is ineffective, inconsistent, and ultimately dangerous:

- It is ineffective because it ignores the very causes of the crisis: the combination of rising inequality, excessive leveraging and de-regulation of the financial sector.

- It is inconsistent response because IMF and OECD experts are aware that the most effective way to deal with the unsustainable rise in sovereign debt is to put an end to the unhealthy flirt between private sector finance and government balance sheets. The suggested response ignores that priority. Instead the only policy "deal" on offer is to immediately accept austerity measures with immediate effect that will hit working people directly, in return for some vague promise to reform the financial sector in a distant future.

- It is dangerous because the fiscal consolidation packages currently being introduced may have lasting consequences on OECD societies in terms of income and welfare distribution. It may also have political implications if fiscal policy is taken out of the hands of democratically accountable institutions.

Nota bene: which "OECD-IMF Response"?

5. To characterising the "Response" by the OECD and IMF to the crisis is no doubt a simplification. This paper draws on a selection of OECD and IMF flagship publications, considered to have had a significant influence on governments, ministries of finance, and the broader community of economic and financial commentators. For the OECD these include articles published in the "Financial Market Trends" semi-annual publication (OECD 2010acde & OECD 2011a), chapters of the semi-annual "Economic Outlook" publication (OECD 2010b) and the Going for Growth annual publication (OECD 2010m & 2009c). As for the IMF, the paper draws on the series of "Fiscal Monitor, World economic and financial surveys" (IMF 2010abc).

6. Comments and statements made in the media by various OECD and IMF officials and which run counter to this consensus have not been taken into account, as they may not always coincide with the key policy messages. This may give a slightly biased and perhaps excessively negative view of the OECD and the IMF, in so far as such individual public comments by key figures (as well as research and working papers) may anticipate more profound policy changes within the institution. One may e.g. hope that recent statements by the IMF Managing Director in favour of greater coherence with the ILO and a "holistic approach" to recovery that would focus "not only on standard macroeconomic and financial policies, but also on job creation and social protection"[1] will eventually shift from words into action.

THE LOOMING SOVEREIGN DEBT CRISIS

7. According to latest OECD projections, the OECD GDP growth should reach 2.3% in 2011, including 1.7% for the Euro area, 2.2% for the US, 1.7% for Japan (OECD 2010b). The IMF (2011c) foresees a two-speed "recovery": sluggish within the Eurozone (1.5%), big and quick in emerging economies (6.5%), roughly in between for the US (3%). The term 'recovery' is inappropriate. In previous economic recessions US employment typically

[1] http://www.imf.org/external/np/sec/pr/2011/pr1123.htm

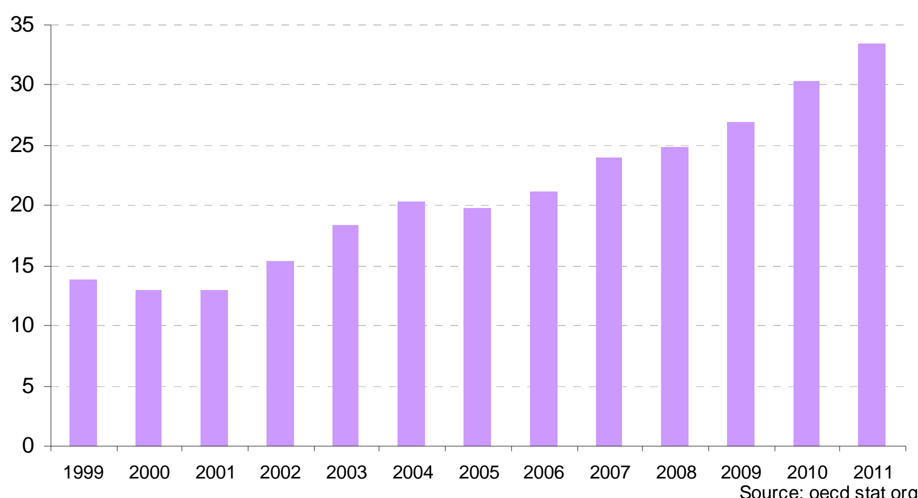
dropped by 3-5% and then returned to pre-crisis level after 1-2 years. In 2009-2010, employment fell by 6% following Lehman's' collapse in 2008 and still is 5% down from pre-crisis level after 3 years (IMF 2010a). The unemployment rate across OECD will remain at a high 8.1% level in 2011, compared to 8.3% in 2010 and 5.7% in 2007 (OECD 2010b). The feeling of economic insecurity has spread across societies. From a working family perspective, this 'recovery' looks increasingly like a continuing recession.

8. The mere term recovery is also a misnomer, when one considers the current state of financial markets and that of government debt markets. The massive bail-out the financial sector in 2008-2009 has led to an equally massive transfer of debt from the private financial sector onto the government and taxpayers' balance sheets. This is a lose-lose situation. The bailouts came at a heavy price for government and yet did not save the financial system. "We are in a period of significant uncertainty for financial stability" says the IMF (2010b). For the OECD (2010a), OECD governments have to face "intertwining of sovereign and banking risk", notably in the Euro area; they have to simultaneously manage sovereign and banking balance sheet restructuring, reforms to the regulatory and supervisory frameworks of the financial system, and insufficient access of the real economy to credit financing; this, in turn, affects economic growth.

Worsening conditions leading to riskier debt compositions

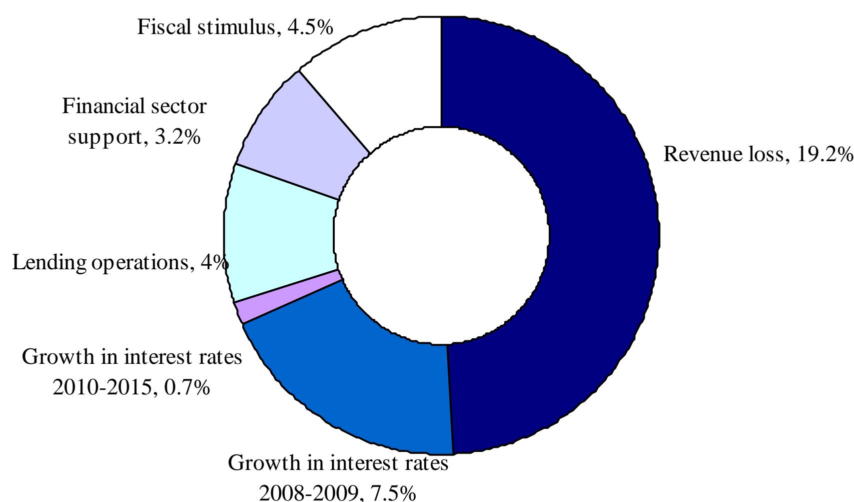
9. Government debt across OECD economies has been soaring since 2008. Total OECD (2010d) central government debt should reach USD 33.4tr by the end of 2011 (EUR22.2tr or 71.7% of GDP), general government debt (i.e. central, local and other public liabilities) should reach 100% of GDP. Compared with 2007, total OECD government debt will rise by +30% GDP points by 2012, which according to the OECD (2010b) is more or less in line the most "severe banking crises" between 1980 and 2006. The number of OECD countries with over 100% GDP debt levels will increase from 3 before the crisis to 8 in the coming decade, while the number of countries with debt levels above 80% GDP should more than double. The main cause of this in most of the OECD economies has been the collapse of growth and hence tax revenues as a result of the recession – not profligate spending.

Figure 1. Total OECD central government debt 1999-2011 (in USD trillions)



10. At face value, the upfront cost of bailing out the financial sector and the stimulus packages that were hastily designed and implemented in 2009 represent a minor factor in explaining the debt increase. As shown in the graph below and reported by the IMF (2010c) of the 39% points of GDP increase in the debt ratio across G20 OECD economies, about two-thirds is explained by revenue weakness and the fall in GDP during 2008-09 (+19.2% due to loss in tax revenues and +7.5% due to the rise in interest rates and debt service). Fiscal stimulus packages including lending operations to support the real economy (students, SMEs, car purchasing, etc.) have accounted for a fifth, while direct support to the financial sector to less than 10%.

Figure 2. Sources of the +39.1% of GDP increase in G-20 OECD sovereign debt 2008-15



Source: IMF 2010c

11. Not all OECD economies are affected in the same way. Debt growth should be reverted by 2013 in about half of OECD economies but should continue to rise for another third. Debt levels in Canada, Korea, Sweden and Switzerland in particular should actually start decreasing in 2011. The OECD expects debt ratios to continue increasing beyond 2012-2015 for Ireland, Greece, Spain and to reach +40% (compared to pre-crisis levels) for the US and +70% GDP for Japan by 2025. By contrast, the IMF (2010a) expects debt ratios of non-OECD emerging economies to "resume a downward trend" as early as 2011.

12. The post-crisis rise in government debt has been accompanied by changes in debt issuance and composition. Under pressure to finance the bail-out of banks that were near insolvency, as well as the stimulus packages that followed – and all on very short notice -, issuance conditions have worsened. Several auctions in the primary markets have been postponed or cancelled and liquidity pressures (low level of trading) in secondary markets have increased. Accordingly the share of short term debt (i.e. treasury bills, or "T-bills" whose maturity is below 12 months, typically 3 months) has increased compared to long term debt (treasury bonds, or "T-bonds" whose maturity often is 10 years). The OECD (2010a) reports that "in countries with extreme market turmoil, operations were for some time restricted to T-bill issuance while T-bond auctions were suspended". Accordingly the share of short-term debt in total grow borrowing needs increased significantly from 64.9% in 2007 to 71.1% in 2008 and should stand at 67.8% for 2011.

13. The share of foreign holding in total government debt has also been increasing. This is not a new trend; foreign holdings have continuously increased in the past decade, but the rise has been more pronounced since 2008. Here too there are important disparities across

countries. Foreign holdings account for approximately half of the US government debt. At the other end, Japan and Canada rely almost exclusively on domestic investors. In Europe, exposure is particularly pronounced where cross-country capital flows are exempted from exchange rate risk, as is the case of the Euro area.

14. Increasing reliance on short-term borrowing and/or on foreign capital is typically viewed as vulnerabilities by the markets, because it exposes to higher levels of market risks, be it interest rate or foreign exchange risks. As noted by the OECD (2010a) "increased dependence on short-term borrowing can rapidly balloon future interest costs for debt rollover, particularly where inflationary expectations are also changing". The US debt is particularly exposed to short term obligations. Nearly a third of the US government debt was due in 2010. By opposition the UK debt has an average maturity that is double that of the US and ranks highest within the OECD. Accordingly, even if marginal interest rates on government debt are high, the overall interest rates, and hence the debt service, still can remain within reasonable proportions if the debt structure leads to relatively long maturity. Interestingly, Greece has the second longest maturity after the UK and, in theory could still "buy time" vis-à-vis the markets before the total government interest bill "becomes too high" (IMF 2010a). Short term and foreign public debt also have implications in terms of contagion risks. Disruption in an individual government bond market with substantial levels of cross-border holdings can quickly spread across economies and prompt herd-like behaviour by investors (IMF 2010b).

How reliable is sovereign rating?

15. Sovereign debt ratings – as determined by rating agencies or by the credit default swap (CDS) markets – have deteriorated considerably as a result of the rapid expansion of government debt, and with that interest rate spreads have increased. Greece and the other "peripheral" EU economies have had to pay increasingly higher marginal interest rates on their borrowing. Yet the reliability of sovereign ratings has become subject to caution, to say the least. First, and as noted above, government bond secondary markets have faced serious liquidity problems – investors have been holding on the bonds, not trading them. For the OECD (2010a) "the information value" of the yield curve for government bills and bonds has become "less reliable"; in many instances, the auction results have served as a proxy for price discovery. Second, sovereign rating is more complex to proceed and is inherently less reliable than corporate rating. Unlike corporations the collateral for a government bond cannot easily be measured on the government's balance sheet; rather, it is to be found in the "the good standing" of the government in place and in situation of market stress its "willingness" to raise taxes or to cut on public expenditures (OECD 2011a). Hence sovereign rating relies on a good dose of subjective judgement. The definition of sovereign risk itself leads to several interpretations. It is not necessarily limited to the effective risk of a default on repayment of loan, for which only longer-term debt sustainability criteria would be needed. It can also encompass short term considerations with regard to the issuance conditions (OECD 2010a). Third, credit rating agencies (CRA) have come under fire for the structural conflicts of interest generated by their business model – the issuer pays for the rating, not the consumer/investor. Prior to the 1970s, the CRAs were remunerated by investors; that provided for the needed independence. Since then the CRAs have moved to issuer-pay model which proved to be much more profitable (OECD 2010n).

16. Equally problematic for the crisis-hit countries is the fact that markets fundamentally under-rate sovereign risks. This is because markets demand a risk premium – an excess return – compared to "the risk-neutral rate" and because such premium is not readily observable as it

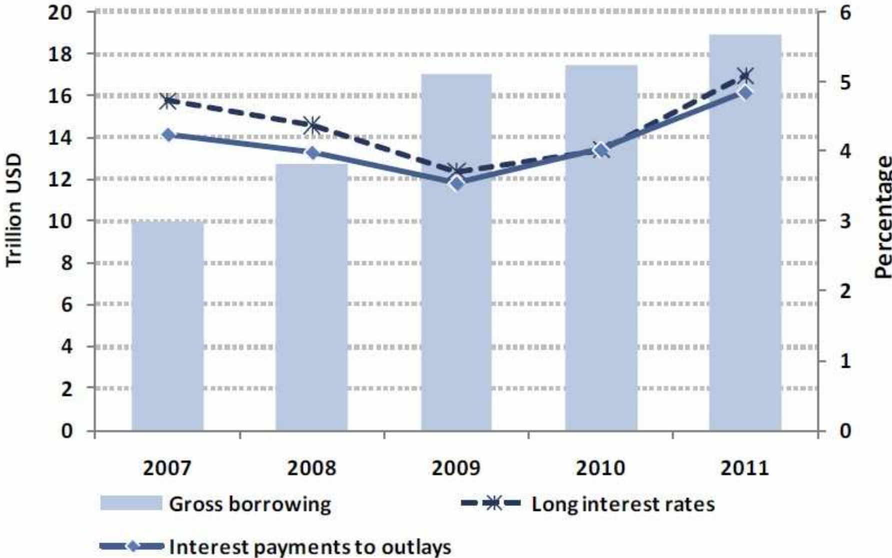
will be function of other factors such as the markets' current risk appetite and risk aversion (OECD 2011a). This problem is particularly true for the CDS markets which are supposed to measure and reflect the expected risk of default. For the OECD (2010a) "the fact that CDS spreads are influenced not just by economic fundamentals but also by market factors of demand and supply means that there may be times when these indicators give conflicting messages". For the IMF (2010a) "CDS spreads, just as any other asset price, depend on the global level of risk aversion in addition to the actual probability of default of the sovereign" which "has likely weighed on the price of sovereign protection, without implying any relation to higher default probabilities". Investor behaviour itself can be driven by "rumours", "fear" rather than a rational understanding and assessment of the fundamentals. For the OECD (2010a) the "uninformed or irrational" behaviour of markets can in fact have a self-feeding function in the deterioration of the crisis leading to "a self-fulfilling negative outcome".

The threat of rising interest rates

17. Yet another major concern lies with the evolution of interest rates. In the run-up to the crisis, long-term interest rates across OECD remained at exceptionally low levels. It was the period of "great moderation", a phenomenon that was first attributed to the deflationary effect of global trade and investment until it became clear (though too late!) that it also reflected under-priced market risks and the creation of multiple speculative asset bubbles. In the aftermath of what was then the "credit crunch" in 2008, interest rates remained at low levels thanks to the exceptional interventions by OECD central banks.

18. For the OECD (2010a&b), interest rates are likely to increase in the future. Current quantitative and credit easing programs may phase out while governments will face "increased competition in raising funds from markets" which in turn will "push the prices of sovereign debt downs and yields (further) up". Any rise in interest rates in the near future could well be sudden as a result of changing market expectations regarding inflation. Higher rates would increase the financing cost of sovereign debt particularly that of government debt whose maturity is short, as is the case of the US (OECD 2010e). Towards the end of2010, government bond yields across OECD already started to pick up as shown in the graph below. Interest payments have risen concomitantly.

Figure 3. OECD Gross borrowing, interest payments and long interest rates 2007-2011



Source: OECD 2010d

19. So far, Japan has been a notable exception to the current deterioration in sovereign risks. By the numbers the country's indebtedness is enormous. And yet the Japanese government bond market has not been disrupted. The country has a high level of private savings and enjoys a large domestic investor base, including the largest pension fund in the world (the GPIF, USD1.4trn in assets). Japanese investors finance a large proportion of the debt and have been willing to do so at extremely low yields. Only a tiny fraction of the Japanese debt is held abroad. While the effects of the earthquake and tsunami that hit the country in March 2011 are still unfolding, it may well be that this home bias could reduce in the future, including as a result of ageing population. The GPIF recently announced that it would become a net seller of Japanese government bonds in 2011 to cover rising pension benefit payments[2].

THE GOVERNMENT LIFELINE TO THE BANKING SECTOR

20. Profitability of the banking sector has recovered promptly from the credit crunch in 2008. Bonuses in 2010 – reporting on activities conducted in 2009 – were close to pre-crisis levels. Those for 2011 are expected to break new grounds. According to the OECD (2010a), there has never been such a rapid recovery of the sector in the history of banking crises. An "enormous amount of restructuring" within banks has been achieved; the OECD notes that "fixed costs have been shed and labour costs have been more flexible; consequently, profits are improving, despite little change in the top line revenues". The recovery also is visible in terms of asset holdings. According to Simon Johnson (2011b) the largest US "banks are now bigger, in dollar terms, relative to the financial system, and relative to the economy, than they were before 2008. […] At the end of the third quarter of 2010 […] the assets of [the] largest six bank holding companies were valued at around 64% of GDP – up from around 56% before the crisis and up from merely 15% in 1995".

21. However, the recovery appears strictly limited to banks' profits. Looking at their function in the economy – lending to households and to companies –, the recovery is no-where near yet. Access to credit has improved very marginally since 2008. Across OECD economies, small and medium enterprises and even smaller financial institutions still face difficulties to fund their activities. According to the IMF (2010b) credit growth may remain weak in 2011 and accordingly could feed a "negative feedback loop to the real economy".

22. Both the OECD and the IMF also have doubts about the true healthiness of bank accountings. For the IMF (2010b), "structural weaknesses in bank balance sheets remain". Of the USD2.2tr in writedowns and loan provisions caused by the crisis between 2007 and 2010, banks have yet to realise in their accountings some… USD550bn. To appease public concerns and the markets, US and European authorities conducted "stress-tests" on their domestic banks in February and June 2010 respectively. The OECD has been sceptical at the methodological validity of these tests, particular in Europe. "The stress-tested sovereign shock" writes the OECD (2010b) "left out the bulk of holdings in the banking book". OECD experts are alarmed at the absence of any leverage ratio requirement in Europe and, the reliance on the self-declaratory approach of the Basel II prudential framework (Bankers are

[2] World's biggest pension fund may sell Japan bonds for payouts - Global Pensions, 24 February 2011 - http://www.globalpensions.com/global-pensions/news/2028756/world-s-biggest-pension-fund-sell-japan-bonds-payouts

free to determine their own level of "risk-weighted" assets in calculating regulated capital ratios). In the US concerns remain with the still weak situation of households' balance sheets and the real estate markets. According to IMF (2010b) estimates, should the US real estate market experience another "significant" downturn, US banks would need USD13bn in fresh capital at short notice to meet the 4% Tier 1 common capital ratio under Basel II.

The upfront cost of bailing out the bankers

23. Governments have a lot at stake in a prompt and true recovery of the banking sector. Since November 2008, they and their central banks have resorted to exceptional interventions to help normalise access to credit and maintain or reduce interest rate levels. Central banks have injected massive amounts of liquidity. In the Euro area banks still rely extensively on ECB liquidity support programmes for their wholesale funding (by opposition to corporate and households deposits). ECB liquidity support accounts for over 40% of Euro-zone banks' total liabilities, which compares with circa 25% in US, the UK and Japan (IMF 2010b). Government treasuries and special purpose government funds also have purchased large chunks of 'toxic' assets from the banks and have injected fresh equity (though they have seldom dared exercise the shareholders rights associated).

24. Government injections in the banks' capital and the repurchase of toxic assets have helped. As reported by the IMF (2010b) "the average Tier 1 capital ratio in the global banking system rose to over 10% at end-2009, although much of this is due to government recapitalization". Inevitably that came at a cost for taxpayers. As shown in the table below, total cost of capital injections and banks' asset purchases by the UK, US and German governments amounted to over USD1tr end of 2010, or 5.4% of the three countries' total GDP. As of June 2010, USD809bn still have to be recovered (USD265bn have been recovered in the form of reimbursement by the banks or re-sale of the toxic assets). Considering that the UK, the US and Germany account for three quarters of G20 governments' direct interventions, the total cost worldwide of bailing out the financial sector between 2008 and 2010 approximates USD1.4tr.

Table 1. Net cost of government bailing out of the banks in Germany, the US and the UK

In %GDP	**Direct support**		**Recovered**	**Net direct cost**
	Pledged	**Utilised**		
Germany	6.8	4.7	0.0	4.6
UK	11.9	7.3	1.2	6.1
US	7.4	5.3	1.7	3.7
Average (end-June 2010)	7.9	5.4	1.4	4.1
In USD bn	1549	1074	265	809

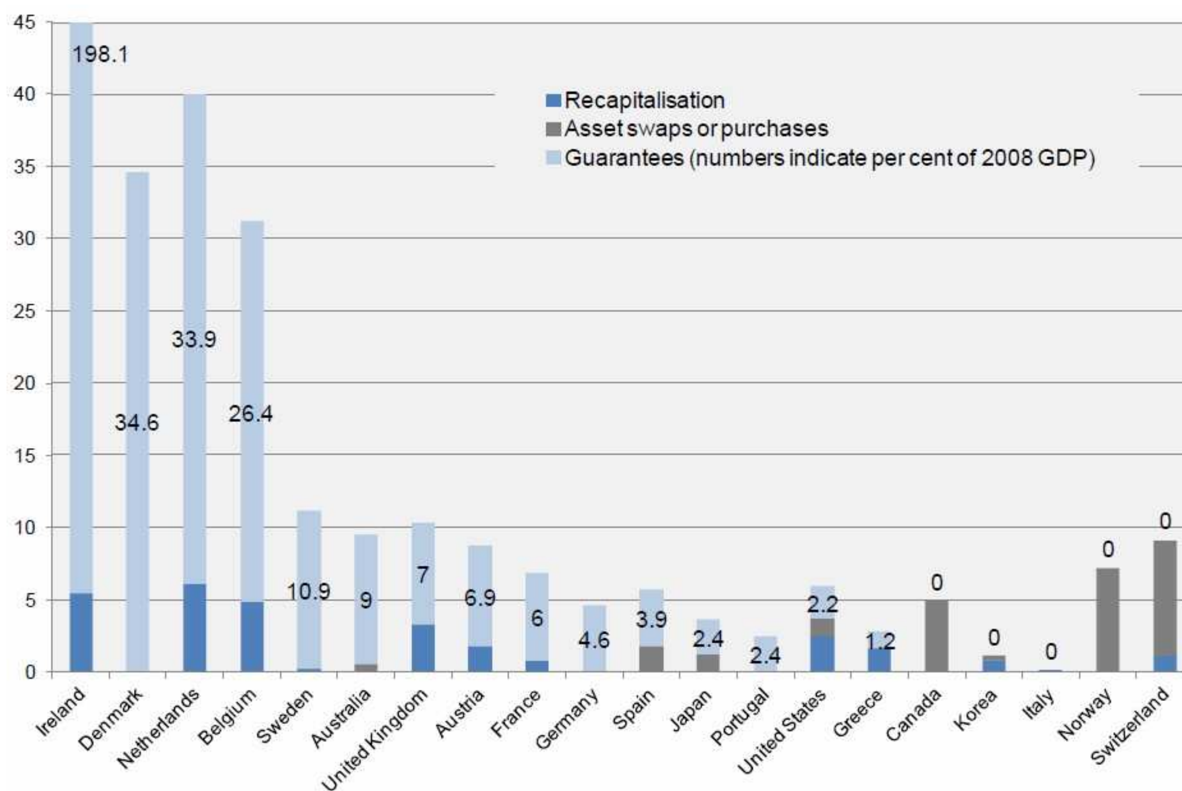
Source: IMF 2010a

Rising contingent liabilities resulting from 'too big to fail' regulatory failures

25. Government financial positions have been made worse as a result of the additional support to the banks in the form of government insurance guarantee schemes on bank bonds. These programmes played a crucial role in facilitating banks' access to wholesale funding in 2009. They accounted for roughly three quarters of total OECD-based bank issuance between September 2008 and March 2009, and almost entirely replaced non-guaranteed issuance in the

UK during that period (OECD 2010a). Thanks to these programmes, overall issuance of bank bonds increased significantly, particularly in the UK, Australia and in the US – where issuance almost doubled during that period (OECD 2010c).

Figure 4. Composition of financial support measures in % 2008 GDP



Source: OECD 2010c

26. While government guarantees do not generate upfront cost for taxpayers when they are issued, they do have significant implications in the calculation of government "contingent liabilities" which in turn impact sovereign rating. According to the IMF, contingent government liabilities in the UK are equivalent to 40% of the country's GDP and exceed 15% in France and Germany (IMF 2010a). Should contingent liabilities materialise – for example through the spill-over effect generated by an individual bankruptcy – the impact on sovereign rating would be significant. To make matters worse, the extraordinary government support programmes are not to be phased in anytime soon. "Public support that has been given to banks in recent years will have to be continued", says the IMF (2010a), as long as prudential capital buffers are not raised "to levels that ensure that banks have adequate access to funding markets" (IMF 2010b).

Table 2. Largest OECD government bank bond guarantee programmes (October 2008 – May 2010)

	Total issuance (in EUR Bn)	**Nb of benefiting banking groups**	**Average maturity (in months)**
USA	248	42	33
Germany	184	11	27
UK	147	14	30
France	128	Not disclosed	33
Australia	110	20	40
Ireland	61	10	30
Netherlands	47	6	46

Source: OECD2010c

27. Government exposure to the banking sector has heightened with the emergence of the problems posed by large financial groups considered ‘too big to fail’, and the related lack of proper regulation and supervision by public authorities. According to a recent US Congress review, the “most significant legacy” of the Trouble Asset Relief Programme is “the moral hazard and potentially disastrous consequences associated with the continued existence of financial institutions that are too big to fail” (SIGTARP 2011 cited in JOHNSON 2011a). Recent developments in the sovereign credit rating methodology of Standard & Poor’s show that these implicit exposures of government to bank failures are now fully captured in both private banking (S&P 2010) and sovereign rating (S&P 2011).

28. In sum the financial risks borne by taxpayers and by the bankers have become closely interrelated. As noted by the IMF (2010b), “the health of the banking system and the sovereign have become more closely intertwined as a result of the unprecedented public support for banking systems during the crisis.” This leads to a re-interpretation of what sovereign risk means. As discussed above, sovereign risk has traditionally been associated with the risk that a government “unable or unwilling to meet its financing needs and payment obligations, will default on its debt”; a definition indeed appropriate to the debt crises that hit emerging economies in the 1980-1990s (OECD 2010a). It is however much less so in the current situation. Even if the explicit government liabilities may *prima facie* be a on a long-term sustainable trajectory – or so the OECD argues – sovereign risk could still be affected by the explicit contingent liabilities (such as bank bond guarantees), as well as by the implicit liabilities arising from expected government support to any future bank failures. For the OECD (2010b), this reassessment of government contingent liabilities means that public budgets have become “more vulnerable to any future financial crises”. Such a scenario is all the more of concern that current IMF and OECD projections of debt sustainability do not factor in their occurrence.

DEALING WITH THE DEBT

29. So far governments and central banks have responded to the looming sovereign debt crisis by engaging quantitative easening policies to avert any rise in interest rates. And indeed, quantitative easening has helped to keep bond yields at reasonable levels. However it is hard to contest the need for more proactive measures to halt the explosive rise and subsequently to engage gradual reduction in sovereign debt burdens, as well as government contingent liabilities in the years to come. The question is how to proceed, given the many constraints and challenges that are posed to governments. On paper, there are multiple ways to address government debt un-sustainability.

- The real burden of government debt can be reduced through higher inflation or, as far as foreign holdings are concerned, through currency devaluation. Such measures would have an immediate effect on the debt burden. They would however be costly to reverse and could soon get out of control. Politically, such approach would not appear realistic, notably in Europe where monetary policy is under control of the ECB. A much less radical solution consists in pooling or transferring the debt service burden or default risk to other countries or to international financial institutions. IMF loans are supposed to substitute to markets when government debt becomes unsustainable. Euro-bonds constitute another form of pooling whereby Eurozone members issue debt to help indirectly re-finance individual members.

- Another option consists in debt restructuring. By imposing a 'haircut' to the principal or to the interest of government debt, the debt service burden would be alleviated in the short term. Many emerging economies have 'benefited' from debt restructuring in the 1980-2000. The most visible and ambitious initiative was the Heavily Indebted Poor Country initiative by the IMF and the World Bank in the early 2000s. Debt restructuring so far has not been considered as an option – at least not officially - by governments, even for the most crisis-hit countries in Europe. Debt restructuring will hit creditors, domestic and foreign holders indistinctively.

- The third avenue for debt reduction – and one that clearly is favoured by the OECD and the IMF and committed by the G20 – is to engage fiscal consolidation whereby debt-service burden is financed by rapid elimination of government budget deficits followed by several consecutive years of budget surpluses. Fiscal consolidation can be financed by cutting public expenditure, raising taxes or both. With fiscal consolidation, it is the population, especially those at the lower end of the income distribution, who are most affected. If consolidation happens simultaneously in several closely connected economies, it can lead to self-feeding economic depression.

- A debt reduction strategy can also be completed by structural reforms to boost the rate of nominal growth and to "export its way out" of the debt crisis. Reforms usually aim at flexible labour markets, increasing market competition, cuts in welfare rights (pensions, education, health) and cross-border liberalisation (trade, investment, capital flows) to improve corporate international competitiveness. The effects are on the medium term, hence structural reforms alone will not solve the urgent problem of a sovereign debt crisis. As with fiscal consolidation, under this low-road-for-employment scenario, it is the people who usually pay the price of debt reduction.

Debt restructuring

30. A key factor in making debt restructuring a serious option to consider is the perceived incapacity of the government to proceed with the necessary adjustments to gradually reduce the debt-service burden through budget surpluses in the medium term. The higher the required budget surplus, the longer the period of consolidation, the more likely debt restructuring will be considered as an alternative solution. Other factors will be at play. For example, the probability of restructuring will rise for government debt in which foreign holdings represent a significant amount, because such foreign ownership represent a net transfer of wealth abroad – conversely it will decrease if domestic banks holds a considerable amount of the government debt. It will also rise if markets perceive no other alternatives, including political alternatives (such as a coordinated bailout by other countries or by the IFIs), and accordingly will be reluctant to roll over existing and finance new debt (OECD 2011a).

31. The likelihood of debt restructuring of Greece is still a political taboo in Brussels. But prominent experts and market analysts have different views. Several reports by asset managers point to the un-sustainability of the Greek debt. For Bruegel (2011), the Brussels-based think tank, debt restructuring is the only viable alternative[3]. Even OECD experts

[3] "Even under the optimistic scenario, the primary surplus required to reduce the [Greek] debt ratio to 60% of GDP in twenty years would be 8.4% of GDP [and] would reach 14.5% under the cautious scenario. This would imply devoting between one-fifth and one-third of tax revenues to interest payments on the public debt. Over the last 50 years, no country in the OECD (except Norway, thanks to oil surpluses) has ever sustained a primary surplus above 6% of GDP. Even less ambitious targets would require politically unrealistic surpluses. Our conclusion therefore is that Greece has become insolvent and that further lending without a significant enough

(2011a) anticipate a Greek hair cut. Based on current market expectations and the price of Greek CDS, they have calculated a 20.7% probability of a 30% hair cut by the State of Greece in 2011. That probability rises to 36% in 2012 and 50% in 2013 and continues rising thereafter. The 30% haircut scenario would be at the lower end of past debt restructurings in emerging economies: Russia (45-63%), Ukraine non-resident (30-56%), Pakistan (31%), Ecuador (27%), Argentina (42-73%), Uruguay (13% for non-resident, 23% for domestically held). The OECD on the other hand still considers the situation "manageable" in Spain, Portugal and even Ireland, where debt levels in 2011 are to remain below 70, 90 and 110 % of GDP respectively.

32. A Greek or an Irish debt restructuring is still not considered as an acceptable option by the ECB. For ECB Chief Jean-Claude Trichet, the Irish rescue plan, like that of Greece, "does not comprehend" the notion of bondholders being "compelled to take a haircut on their investments"[4]. The traditional argument against debt restructuring is the irreversible impact it would have on the country's future access to global financial markets. Once a default, foreign investors would 'punish' the country by excluding it from international credit markets. That view however, is contested by OECD experts for which exclusion is not "the lesson of history". "Markets will buy debt that has been restructured", argues the OECD (2011a), "if the restructuring is perceived as enabling the issuing governments to service their obligations in the future". For its part, the IMF also has expressed scepticism at debt restructuring option. The main problem with current OECD sovereign debt, the Fund argues, lies in the growing primary budget deficits, not in the growth of the debt service – as was the case for developing economies in the 1980-2000s. A 50% haircut on the interest rates would only decrease marginally the budget cuts needed to stabilize the current debt-to-GDP (IMF 2010a).

33. In the case of Europe, opposition to restructuring is also fuelled by the risk of contagion across the Eurozone, given the close interconnectedness of the European banking sector. If Greece needs to be saved, it is first and foremost to protect German and French banks. For Ronald Janssen of the ETUC, the Greek "rescue" by the IMF and EU in May 2010 was really about "exchanging debt ownership to save European banks and creditors" (CEPR 2010). Janssen argues that through excessive austerity the IMF/EU fiscal consolidation plan will trap the country in a prolonged period of stagnation and deflation, is unlikely to "leave Greece's finances on a sustainable path", and, accordingly, will not restore the country's access to financial markets. This analysis is further supported when considering the enormous exposure of European banks to the Greek, Portuguese, Spanish and Irish sovereign debts. In June 2010 German banks held EUR324bn worth claims vis-à-vis these countries, French banks EUR252bn and British Banks EUR222bn (OECD 2010e). According to OECD research (2011a), a haircut of 30% on the Greek sovereign debt would wipe out 31% of the tier 1 capital of German Hypo Real Estate, 8% and 10% of WGZ and Deutsche PostBank respectively, 6% and 4% of French Dexia and Société Générale respectively. Furthermore several German banks with significant exposure to the above 'peripheral' countries are state-owned. A haircut hence could potentially expose German taxpayers through explicit German government contingent liabilities.

34. Rather than restructuring, the ECB view is to pursue a 'wait and see' or a 'forbearance and time' (OECD 2011a) approach. Accordingly private banks should be given time to make up their past losses through future operating incomes. In the meantime, sovereign debt crisis hit economies (not least Greece, Portugal and Ireland) would go through painful consolidation programmes so as to maintain the banks' creditor right over sovereign debt claims. The

debt reduction is not a viable strategy. […] With a debt-to-GDP ratio scheduled to reach 150 % in 2011 and to continue rising in subsequent years, the country is clearly on the verge of insolvency." (Bruegel 2011)

[4] Trichet reiterates opposition to Irish debt restructuring, February 2011 http://www.irishtimes.com/newspaper/finance/2011/0208/1224289258019.html

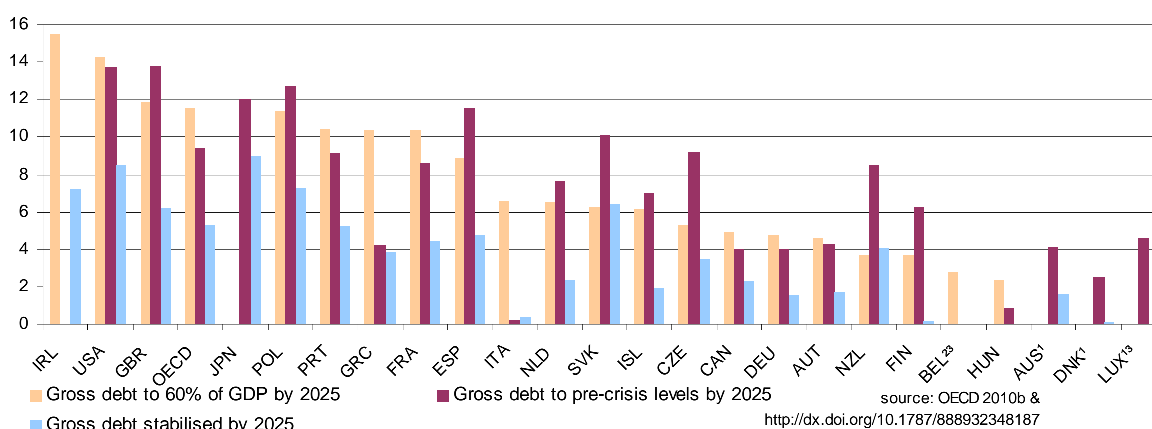
Bruegel institute strongly warns against such approach. In a hint to Japan's lost decade in the 1990s, it states that "history suggests that such a 'wait and see' approach is a dubious strategy" (Bruegel 2011).

Fiscal consolidation

35. In their June 2010 meeting in Toronto, the G20 heads of states committed to "at least" halve their respective budget deficits by 2013 and to stabilise or reduce their debt to GDP ratio by 2017. Substantially, the majority of the plans are financed by cuts in public expenditures, not by tax revenue increases, with the notable exception of China (but whose initial tax wedge is very low by OECD standards). In Japan, deficit reductions measures are modest relative to the rest of the OECD, with a deficit reduction of 1% in 2012. Until the end of 2010, the US was the only large OECD economy to have maintained counter-cyclical fiscal stimulus. The Republican Party won the majority at the lower house of the US Congress in November 2010 and has made clear its intentions to move toward public cuts and… tax cuts (hence debt-financed tax cuts). It is in Europe however that the most abrupt adjustments in public expenditures have been announced, particularly in Portugal, Spain, and the UK, including cuts in wages, pensions, and public investments.

36. The IMF and the OECD have shown great enthusiasm in supporting OECD economies' shift from stimulus to fiscal consolidation in 2010. For the IMF (2010a) current adjustment plans are "on the right trajectory" and need "to be sustained". But both institutions want more. The Fund deplores that only a few countries have specified "concrete longer-term targets" to bring debt levels back at pre-crisis levels, in the fear that countries "may aim at stabilizing debt at high post-crisis levels", which would raise real interest rates and lower potential growth over the longer run. For the OECD (2010b) "the slow pace of consolidation and the high levels of debt reached may in practice not be sustainable in some countries. The extent of fiscal consolidation needs to be much larger if the aim is to significantly reduce debt-to-GDP ratios rather than merely stabilise them." As shown in the graph below, budget austerity should reach -5.5% of GDP on average within the OECD to stabilise debt levels by 2025 (over 110% of GDP), of which -2.3% should be achieved by end 2012. . Consolidation requirements would be much tougher if the objective is to return to pre-crisis debt levels: -9.5% on average for the OECD – and -11.5% to reach 60% of GDP levels.

Figure 5. Budget consolidation to stabilise debt by 2025, to resume to pre-crisis levels & to 60% of GDP



37. These projections do not take the impact of demographic change into account. For a typical country, the OECD argues, additional public cost savings equivalent to 3% of GDP will have to be found over the coming 15 years to meet spending pressures arising from ageing populations. This would amount to additional consolidation requirements of about 0.25% of GDP per year. The adoption of "credible" fiscal consolidation plans in the short term is also needed to restore financial market confidence, so as to secure some access to the bond primary market for governments, but also, importantly, for the domestic banking sector. "Market pressure" says the OECD (2011b) "appears to be a key factor in determining the announcement of a consolidation plan, including the size and concreteness of the plan". Looking at the consolidation plans announced in 2010 the OECD has identified four groups of countries:

1. Countries that announced substantial consolidation in response to market concerns about public finances, including: Greece, Hungary, Ireland, Portugal, Spain.
2. Countries that announced pre-emptive packages in terms of relatively sizeable medium-term consolidation, including: Estonia, Germany, the Netherlands, New Zealand, the Slovak Republic and the United Kingdom.
3. Countries that have comparatively high fiscal consolidation needs but have yet to announce large consolidation, including: France, Japan, Poland and the United States.
4. Countries that have comparatively low fiscal consolidation needs, including: Australia, Chile, Finland, Korea, Norway, Sweden and Switzerland.

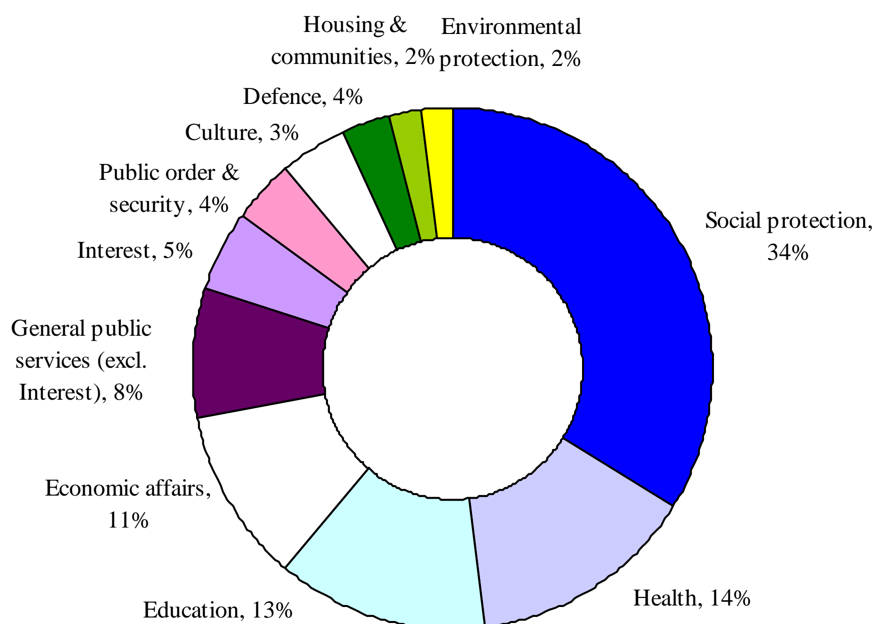
38. However, the IMF and the OECD contend that any "abrupt, front-loaded tightening" would be risky. Given the experience of emerging markets in the 1990s, fiscal consolidation may "overshoot the required policy response" which would effectively send positive signals to the market but would come at the cost of much slower recovery (OECD 2010a). Still, both the IMF and the OECD appear fairly relaxed about the risk of contraction resulting from the tough fiscal consolidation plans. For the IMF (2010a), the negative impact of fiscal tightening on GDP growth is estimated at a multiplier is 0.5 to 1, which for the Fund is a fairly "small" multiplier. The OECD (2010b) also does not appear too worried about spill-over effects between countries that might engage budget austerity simultaneously. Such spill-over effects simply need to be taken into account in designing the budget plans. In fact, the OECD quite optimistically believes that the contraction effects of fiscal consolidation could be compensated in part by the expected reduction in the sovereign risk, which in turn will help keep interest rates at low levels. "While fiscal consolidation remains contractionary in the short run", the OECD says, "lower long term interest rates can permanently boost output in the longer run by raising investment and productivity".

PUBLIC SERVICES AND SOCIAL PROTECTION

39. The way fiscal consolidation is designed obviously is not neutral from a socio-economic perspective. Whether financed by cuts in public expenditure, by tax increases or by both, consolidation will impact different groups of population. Few governments have spread the budget efforts more or less evenly between revenue and expenditure posts. That is not the preferred option for the OECD, for which consolidation programmes that are driven by cuts in public expenditures are likely to be "more successful" that deficit reduction programmes financed by tax increases (2010b). The size of government spending relative to GDP has declined in all but two OECD countries between 1995 and 2006; it fell by 7-10% points in Germany, Canada, Netherlands, Ireland, Spain, Slovak and Czech Republics, and in all the Nordic Countries (OECD 2009b). Still, the priority, we are told, should be public expenditure

cuts including public administration employment, health and, not least, social protection, including pensions. The latter accounted for 34% of OECD-wide government expenditures in 2008 as shown in the graph below.

Figure 6. Structure of general government expenditures (OECD-wide, 2008)



Source: 2011b

Cuts in public administrations

40. The IMF (2010a) and the OECD (2010b) see value in cutting the government wage bill, given its "large part" in government spending (between 10-14% of GDP for the majority of OECD countries) and its immediate effect on the reduction of public deficits. It is argued that public sector pay has become "overly generous" relative to the private sector. Such downward realignment of the public sector would be particularly required for Europe, which needs to raise the international cost competitiveness of the private business. The OECD advises to take the opportunity of an ageing population in the public sector and the upcoming wage of retirements to reduce total employment by reducing replacement rates rather than through direct lay-offs. As shown in the table below, several governments have already proceeded with substantial cuts either through job cuts or through across the board reduction in the wage bill.

41. Other public cost saving measures suggested by the OECD include the introduction or greater use of user fee-based public services, competitive tendering in government procurement and the development of public-private partnerships. Importantly governments are invited to engage new rounds of privatisations on the basis of "cost-benefit analysis". Citing literature of the 1990s[5], the OECD (2010b) is confident that privatised companies become more efficient and that cuts in employment following privatisation contribute to better "reallocation of resources elsewhere".

[5] "From State to Market: A Survey of Empirical Studies on Privatization", William L. Megginson & Jeffry M. Netter, Journal of Economic Literature, Vol. 39. Draft posted on the OECD website: August 31, 2000

Table 3. Job and wage cuts in public administrations announced in 2010

	Jobs	**Wage bill**
Austria	-3000 (federal, by 2014)	
Belgium		-0.7%
Bulgaria	-10%	
Czech Republic		-10% (teachers excl.)
Estonia	-30%	-9%
France	-97 000 (through 50% replacement rate policy)	Freeze
Germany	-10 000 (by 2014)	-2.5%
Greece	20% replacement rate policy	-14/-20%
Ireland	24 750 (by2014)	-13.5%
Latvia		-50%
Lithuania		-8%
Mexico	-30 000	
Poland	-10%	
Portugal	0% replacement rate policy	-3.5% (above EUR1500 monthly); -10% (above EUR4500 monthly)
Rumania	-250 000	-25%
Slovak Republic		-10% (central gvt)
Slovenia	-1% (by 2011)	-14%
Spain		-5%
UK	-330 000 (by 2014)	Freeze
For memo		
France (2007-2009)	-42 000	
US (2008-2009, States & Municipalities)	-110 000	

Source: OECD 2011b, ETUC website, TUAC reporting of OECD meetings on public employment, CEPR 2009 & European Restructuring Monitor

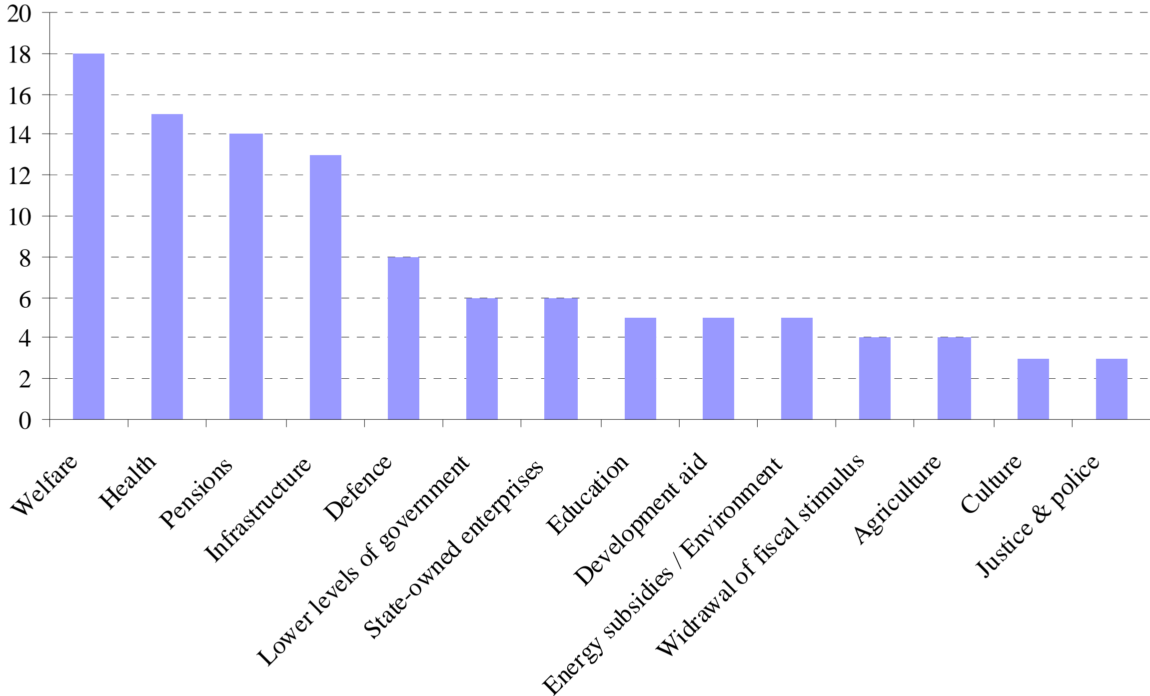
42. The OECD recognises, however, that putting the burden of fiscal consolidation on public sector employment may impact the delivery of public services. Hence “care should be taken” that certain public services are not “unduly affected” or those that “may be more prejudicial” to lower income groups (OECD 2010b). Government should lower the inputs of public services (employment and wages) while “maintaining” the level of output. In this respect, the Organisation sees considerable scope in raising public sector efficiency, particularly in “big ticket” items, such as education and health. It is not always clear how these efficiency gains would be obtained. For example the OECD (2010b) claims that cumulated potential net cost savings could reach the equivalent of 2% of GDP in the health sector. However when looking at the source (OECD 2010f), it appears that the potential gains would average 1.9% (and not 2%), that it would be spread over a 10-year period and that the estimate should be treated with caution, given the “wide uncertainty margin”…

Cuts in pensions and other social protection entitlements

43. Other than public administration, consolidation efforts should target social transfers, including health and pensions. According to the OECD (2010b) on current trends health care, long-term care and pensions costs should increase between 1 and 5.5% of GDP in the OECD area by 2025. Measures needed to prevent the rise in social protection would amount to 0.25% of GDP per year. For the IMF (2010a), health care spending alone should increase by 3.5% of GDP on average by 2030. Accordingly, the Fund calls for “more fundamental reforms” to “strengthen supply-side incentives” and to “reduce the demand for public health services”. For the OECD (2010b), “sizable deficit cuts are to be achieved by freezing or reducing some

social transfers" particularly in some countries including Germany and the UK. More could be done to e.g. limit access to disability benefits, whose growth and number of beneficiaries (6% of the population on average across OECD) are eyed suspiciously by OECD when compared with the coverage rate of Mexico (less than 1%). As shown in the graph below, welfare, health and pensions constitute the three most frequent categories of public expenditures cuts as announced by OECD governments in 2010.

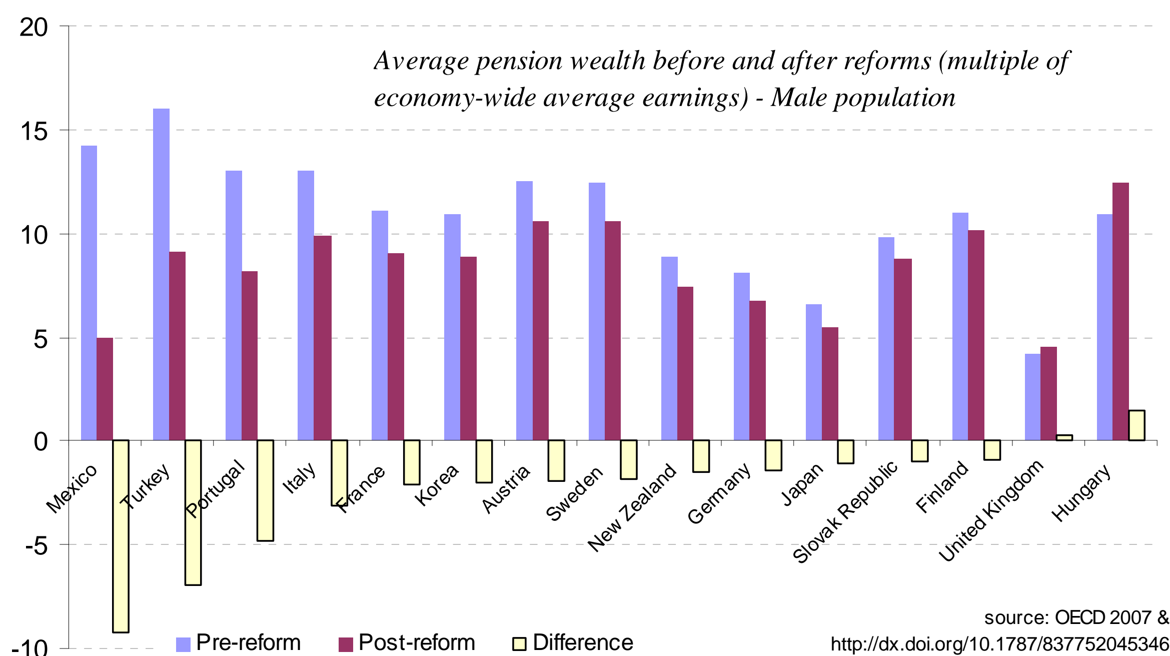
Figure 7. Frequency of major public expenditure cuts by OECD economies in 2010 per category



Source: OECD 2011b

44. It is in the area of pension entitlements that both the OECD and the IMF see the need for urgent reforms to offset rising costs. Future pension costs arising from population ageing are expected to "vastly outweigh" that of the current global crisis, the IMF warns (2010a). Most OECD economies have already gone through substantial cuts in pension rights prior to the crisis, as shown in the graph below. The average pension wealth (i.e. the numbers of annual earnings a person can expect to receive in pension benefits during his/her retirement period) has been reduced by 22% for men and by 25% for women as a result of pension reforms since the early 1990s (OECD 2007). Still, both the IMF and the OECD see scope for further pension cuts. For the Fund, raising retirement age is seen as the best policy option (compared to other selected alternative options such as reducing pension benefits by 15% or contribution rates by 2.25% points). Increasing retirement age by two years would reduce debt-to-GDP ratio by 30% points by 2025 according to the Fund. The OECD (2010b) argues that raising retirement age would enhance social equity because it would foster inter-generational equity (by alleviating the burden of an ageing population to be borne by younger generations) and should support domestic demand in the short term – as people "will have to save less". The risk that in a situation of high unemployment, raising retirement age would add further stress on the labour markets and/or pressurise other social safety nets is, it seems, not considered as a serious threat.

Figure 8. Impact of pre-crisis reforms on pension wealth in a selection of OECD economies (1991-2006)



STRUCTURAL REFORMS

45. Because fiscal consolidation will be inherently detrimental to growth, and could rapidly turn into contraction through spill-overs, the OECD-IMF response also includes medium term structural reforms: reducing administrative burden for private businesses, trade liberalisation and increasing market competition (OECD 2010j), innovation as well as green growth. It is however in the area of labour market that the bulk of structural reforms should take place, so as to increase employment rates and contribute to higher growth. "A durable drop in the unemployment rate of 1% point" argues the OECD (2010b) "could boost budget balances by 0.25-0.75% of GDP".

Flexible labour markets

46. While the intended objective of increasing employment rate can only be welcome, the concrete policy recommendations by the OECD are not reassuring from a trade union perspective, in so far as they remain closely framed within the "Going for Growth" policy framework. Going for Growth is an annual evaluation exercise of OECD economies on their economic performance and the effectiveness of their structural policies. Regarding labour market, it is historically rooted in an employer-centred 'hire and fire' approach favouring wage flexibility, weak labour market institutions including minimalist wage setting mechanisms such as collective bargaining.

47. One can observe a slight 'repositioning' of the OECD Secretariat on labour market reforms in recent draft papers (March 2011) that were circulated to OECD Member States and seen by TUAC, including a more measured approach to wage setting institutions, collective

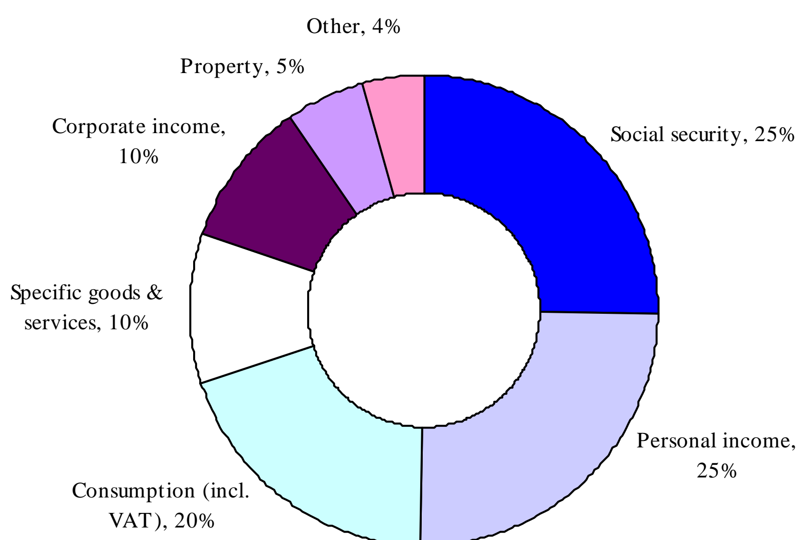
bargaining and unions. Yet the most recent formal recommendations to OECD economies are more of the same. For example, in 2010 and 2011 the Going for Growth recommendations have included:

- Lowering employment protection rights for regular workers in: Chile, Czech Republic, France, the Netherlands, India, Germany, Italy, Japan, Korea, Portugal, Spain, Slovenia and Sweden;
- Easening of dismissals procedures in: India, Indonesia, Germany, Sweden, and Spain;
- Lowering or limiting the increase in minimum wages in: France, Greece, Indonesia, Slovenia and Turkey;
- Reducing replacement rates of unemployment benefits in: Belgium, Finland, Hungary, Luxembourg and the Netherlands; and
- Decentralising and/or elimination administrative extension of collective bargaining agreements in: Belgium, Italy, Slovenia, South Africa and Spain. (OECD 2010o & OECD 2011c)

Regressive tax reforms

48. Taxation is another key area for structural reform. Mandated by the G20, the OECD-led Global Forum on Transparency and Exchange of Information for Tax Purposes has accomplished noticeable progress in enhancing international cooperation to tackle tax evasion. Through the International Tax Dialogue initiative, the OECD is also contributing to capacity-building of tax administrations in developing countries. These are welcomed initiatives. The concerns are elsewhere: the tax policy mix and the balance between direct (personal income, corporate income among others) and indirect taxation (VAT, property). Tax structures are diverse across OECD. On average, and ss shown in the graph below the two major tax categories are social security contributions and personal income (25% of total tax revenues), followed by VAT (circa 20%).

Figure 9. Major tax categories in total tax revenue (OECD-wide, 2008)



Source: OECD 2011b

49. Tax reforms as advocated by the OECD (2009c, 2010g, & 2010m) would not aim at increasing tax revenues, but rather at eliminating tax rules that have a negative impact on growth. The forms of taxation considered by the OECD to be "least harmful" on growth, and hence whose rate should be increased or tax basis enhanced, including property and consumption taxes, such as value added taxes (VAT), are preferred. In particular, raising the rate and/or enlarging the tax basis of VAT (including eliminating special lower rates and exemptions) have been key policy recommendations of the OECD throughout its economic surveys, and of the IMF as part of its Article IV Consultations. Japan and the US are particularly targeted: Japan because of its low VAT rate and its many exemptions, the US because it does not have a VAT at all. In contrast, corporate income tax (CIT), employer social security contributions, taxes on dividends, capital gains taxes, transactions taxes and personal income tax (PIT) – particularly the marginal tax rates on the PIT top revenues – are considered as most harmful because they influence business choices and hence may lead to suboptimal allocation of capital. According to the two institutions, these forms of taxation should be reduced or at least not increased; tax expenditures and tax exemptions should also be eliminated. Even tax expenditures aiming at social outcomes (for example deductions on child raising and children education) are questioned for their lack of efficiency.

50. If well designed, individual measures such as raising property taxes can help reduce income inequalities and divert private savings from unproductive assets (real estate market) toward investment. The OECD admits that its advocated taxation framework is regressive in nature – raising indirect taxation, cutting on direct taxation – and overall will have a negative impact on re-distribution of revenues within the economy and may fuel rising inequalities. However the OECD believes that such equity concerns would be better addressed by "other means" and by targeted social protection schemes. The IMF (2010a) agrees with this perspective; it specifically rejects the concerns about the distributional effects of raising VAT and its impact on inequality: "Concerns that increasing reliance on VAT […] would penalize low income households are misplaced [because] if the incidence of VAT is measured using *lifetime income*, then the regressivity of VAT is *not as strong*"… In fact focussing on the distributional effects "risks highlighting the losers and inhibiting reforms" (OECD 2010g).

The under-taxation of the financial sector

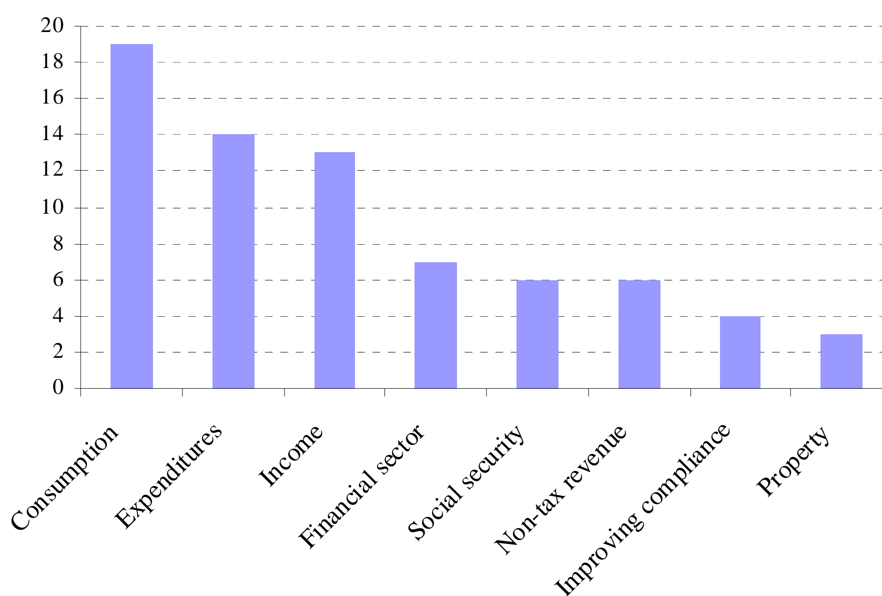
51. Taxation of the financial sector is one of the few policy areas where the IMF and the OECD are not entirely on the same wave length. It is an important aspect of the IMF response to the crisis while it barely appears in the main recommendations by the OECD[6]. It is no small irony to compare the OECD's insistence on broadening VAT with its total silence on the massive VAT exemptions which benefit the financial sector across OECD countries. Historically the financial sector's VAT exemptions have been legitimised on technical grounds; it is argued that the concept of "added value" does not fit easily the business of financial intermediation. But recent academic research cited by the IMF (2010a) shows that such concern appears "less relevant now". The IMF itself has proposed the creation of a Financial Activities Tax (FAT) which would apply to all financial compensation and profits above a certain threshold. Importantly from a fiscal consolidation perspective, the FAT would raise revenues. Although it would have financial stability objectives (it would tax "only the higher returns, as a deterrent to excessive risk-taking"), it is first and foremost presented by the Fund as an alternative to traditional VAT to "compensate for the undertaxation […] of financial services".

[6] Internally the Organisation is developing work on the interaction between tax systems and the "shadow" banking system (such as the tax biases that favour excessive leveraging and tax arbitrage between jurisdictions).

52. The IMF and the OECD also appear distant from each other regarding the creation of a Financial Transaction Tax (FTT). The IMF has conducted serious work on the topic including a formal "staff report" on taxation of the financial sector (IMF 2010d) which was commissioned by the G20. In this report (and a research paper that followed, IMF 2010e) the feasibility of an FTT is not disputed as such, nor are some of its efficiency aspects. In fact the IMF appears not to be opposed to the creation of an FTT; the Fund simply believes that its own proposal, the FAT is better suited. The OECD on the other hand, has not conducted research on the FTT or even engaged formal policy dialogue with its member states as part of its Committee on Finance Markets. Still, that has not prevented OECD staff from publicly or internally dismissing the FTT.

53. On the other hand, both institutions have similar positions regarding the creation of new fee-based bank insurance mechanisms to enhance financial stability. Financial stability insurance mechanisms have been suggested by the OECD (2010i). The IMF-proposed Financial Stability Contribution (IMF 2010d) would apply to the balance sheet liabilities of large financial institutions (at least large banks, perhaps insurance groups as well) and would be calibrated to the degree of riskiness of these liabilities (for example liabilities that are already ensured, such as deposits and presumably government guaranteed bank bonds would be exempted). According to the IMF (2010a) a 0.1% FSC charge could raise 2-4% of GDP over a 10-year period. In addition to those existing already (such as Sweden), several G20 countries introduced an FSC-like mechanism in 2010, including the UK, France, Belgium, Germany. Although sizeable, it should be stressed that the revenue raised by an FSC would be earmarked to financial stability insurance purposes. It may transit via central government funds – and hence would reduce sovereign exposure to contingent liabilities – but its purpose is not to finance fiscal consolidation as such. Overall, and according to the OECD (2011b),

Figure 10. Frequency of major tax measures by OECD economies in 2010 per category



Source: OECD 2011b

The governance of fiscal consolidation

54. The OECD and the IMF attach much importance – understandably so – to improving reporting, forecasting, risk management and other governance aspects in implementing fiscal

consolidation. Both the institutions strongly favour constitutional amendments that "lock in" budget deficit reduction processes in the long term and shield it from democratic political interference. The most vivid example of fiscal rules is Germany: in June 2009, it incorporated budget deficit rule in its constitution. However, the IMF and the OECD acknowledge the challenge that economic cycles pose to any such rigid approach to budgeting. This leads the OECD to favour expenditure rules because they are "less affected by the economic cycle" than deficit rules are (2010b). The IMF-supported concept of "cyclically-adjusted balance" is, according to the OECD, not robust enough to be relied upon; it holds that expenditure rules have the great merit of being relatively transparent in case of breach as compared to deficit rules.

55. Both the IMF and the OECD also favour the creation of "independent" fiscal watchdogs with sufficient powers and influence over government and ministries. Such government arms-length agencies generate "greater discipline", help "boost credibility" vis-à-vis financial markets (OECD 2010a), improve "equity and efficiency", reduce "distortions arising from political incentives" and should be given a "central role in the budget process" (IMF 2010a). Recent examples include the creation in the UK of the Office for Budget Responsibility. It is also this approach that prevailed in the reform of the EU economic governance system and the Stability and Growth Pact adopted end-2010. With the creation of the "European Semester", the European Commission is granted new authority to monitor, and, if needed, to request sanctions regarding the budget policy-making process of each member states on an annual basis. No one will object to the need for fiscal responsibility and transparency at large. There may however be long lasting consequences for democracy if the proposed measures – constitutionalised fiscal rules, empowerment of "independent" experts in the fiscal consolidation process – become another way to shield fiscal consolidation from elected officials.

CONCLUSION

56. Despite the recognition of the rise of inequality as a major problem (OECD Growing Unequal 2008), few OECD and IMF recommendations question the imbalanced growth model. Rather, the unprecedented consolidation efforts and the structural "reforms" they promote will further increase inequality. To bring government debt back to pre-crisis levels, public budgets should contract by -9.5% on average in the near future, and remain in surplus afterwards. Considering the enormity of the social crisis spreading across OECD economies, the cuts in public services and in social protection, as well as, concomitantly, the regressive tax reforms will hit households and the lower income people front on.

57. The discussion on tax reforms exemplifies how little attention is brought to inequality concerns. The OECD (2010b) concedes that the massive public expenditure cuts it is advocating "may have adverse consequences for equity outcomes" – but its response to this concern appears thin, to say the least, and this, in spite of recent work in that field (OECD 2008). It is suggested that social protection and unemployment benefits be "revisited in terms of their effectiveness in reaching envisaged policy goals". The OECD lives with the hope that while the inputs will effectively be cut down, the output levels (including quality of public services) could be maintained thanks to "efficiency gains", better "targeted" services and restructuring: "doing more with less", we are told.

58. Trade union experience with public sector restructuring would rather point to the opposite effect: "doing much less with less". Any restructuring involves substantial upfront

costs. The net effect of the public cuts advocated by the OECD might increase public expenditure in the short term. There is also a substantial risk that governments engage in "panic" cutting – enforcing uniform, across the board cuts in employment and/or wages in the public administration, which soon could get out of control and prove very costly in the medium term. Importantly, the notion that social protection could be better targeted in times of social crisis appears rather illusory with unemployment at 10% and under-employment at 20, rising poverty and social deprivation. The combination of regressive tax reforms, cuts in public services and flexible labour market reform will inevitably lead to further inequalities and undermine the foundations of a sustainable path to growth through solvent household demand. This response will not cure the OECD economies; much on the contrary, it will create the conditions for the crisis to deepen.

59. It is also an ineffective response because the most effective way to deal with the rising government debt lies not in the proposed anti-social and anti-worker fiscal consolidation programmes, but in deep, immediate and irreversible action against global finance, a point both the IMF and the OECD acknowledge. The total worldwide cost of bailing out the financial sector between 2008 and 2010 approximates USD1.4tr, of which over USD800bn have yet to be recovered. Combined with the fall in taxable revenues and the financing of the stimulus packages that followed, this bail-out has resulted in a massive increase in OECD government debt: USD 33.4tr (EUR22.2tr) by the end of 2011 or 71.7% of GDP, a jump of almost +30% GDP in four years. Sovereign debt ratings – as determined by rating agencies or by the credit default swap (CDS) markets – have accordingly deteriorated considerably. Yet the reliability of sovereign ratings has come under fire. In fact the concept of sovereign risk needs to be revisited. It needs to be enhanced to include 'explicit' contingent liabilities – government insurance guarantee schemes on bank bonds – as well as 'implicit' ones – market expectations that large financial groups that have become 'too big to fail' will be bailed out again and again. According to the IMF (2010b), governments need "to manage and reduce their contingent liabilities", and should work to "eliminate the ability of significant financial enterprises in the public or private sectors to enjoy subsidized borrowing costs from explicit or implicit taxpayer support". These contingent liabilities are not to disappear any time soon as long as government inaction will prevail on the regulatory front. Despite a recovery in banks' profit and bankers' remuneration, the idea that the financial sector has recovered is a far fetched one. Access to credit certainly has not, and deep concerns remain with the true healthiness of the banks' balance sheet.

60. In sum, if public budgets have become more vulnerable following the crisis, it certainly is not due to any badly managed or inefficient public services or social protection, or badly designed tax systems; rather, the fault lies with the unwillingness of policymakers to take decisive action on banking and broader financial regulation, which leads to growing exposure of governments to any future financial crises.

61. Finally, it is a dangerous response. The public expenditure cuts which are foreseen will have long lasting social and political effects. Trade unions are well placed to know through their membership that social cohesion is breaking down across OECD societies; they are first-hand witnesses of rising populism within the working class. The political dimension of the crisis, the need to bring back some redistributive justice in the economy, is not factored in the OECD – IMF response. Much on the contrary, their response fuels the risk of weakening democratic institutions if key elements of fiscal policy are transferred away from democratically elected bodies through the constitutionalisation of fiscal rules and the empowerment of "independent" experts in the fiscal consolidation process.

Priorities for now

62. The trade union movement has made policy proposals to exit the crisis (ETUI 2010, ITUC 2009, TUAC 2010), which are often alternatives to the proposed IMF-OECD response outlined in this paper. The key priority for now is to limit the deficit cutting in the short term until economic and employment growth picks up, so as to ensure a viable deficit reduction policy in the medium term. For the ILO (2010), the current "early exit" from the stimulus packages would indeed improve fiscal balances but would prove to be "short lived". Soon, fiscal deficits would "deteriorate once again" as "many workers would move out of the labour market, depriving the economy from valuable resources and reducing the tax base" and "unemployment and labour market inactivity resulting from early exit measures have a strong bearing on spending". By contrast the continuation of "job-centred policies" – such as social protection, unemployment insurance and pension schemes, targeted tax rebates and subsidies, support for tripartism and collective bargaining, and infrastructure spendings – "though costly to the public purse in the short run, would in five years time lead to fiscal deficits similar to those of an early exit strategy".

63. Another priority is – at last – to take decisive action on reforms of the financial sector. As shown in this paper, the key threat to sovereign debt sustainability in the short term, lies not in fiscal policy, but in government exposure to the private financial sector systemic risk, including through contingent liabilities created by financial institutions that are too big to fail. Governments must put an end to this intertwining without delay. The OECD (2009a) calls, as at least implicitly, for splitting the large banks to shield commercial and retail activities – that serve the real economy – from the volatile investment banking activities. The generalisation of Financial Stability Contribution (FSC) type insurance mechanisms together with the creation of an FTT and the IMF (2010d) suggested FAT would help redress the current under-taxation of the financial sector. The consolidation of the supervisory framework must meet the global dimension of finance, including within Europe, which is dominated by too numerous, too fragmented, and still un-coordinated national supervisors. These proposals must be acted upon, as must the current G20–FSB Action plan on financial regulation (Basel III, including additional capital surcharges for large groups and leverage rations, regulation of derivatives markets). In the medium term, a structural shift in economy policy toward reducing inequality is required. A new growth model is needed. This is the objective of an upcoming report by a trade union task force on "exiting from the crisis towards models of more equitable and sustainable growth".

SOURCE

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