

# Economic Outlook

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## Back from the Abyss? Improved Economic Data Meet Heightened Solvency Concerns in Europe

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October and early November economic data have solidified our view, expressed in the previous months' *Economic Outlook*, that the U.S. economy is likely to avoid the double-dip recession feared by some analysts. On a final demand basis (net of inventories), U.S. GDP expanded by 3.5% in the third quarter, the second fastest growth rate of the past five years. The improved news for the real economy was accompanied by broad increases in asset prices, as the MSCI World Stock Index rose by over 16% in the 18 trading days ending October 28.

The good news has been tempered by concern about the sustainability of public finances in Italy, the euro area's largest sovereign bond market and third largest economy. All eyes are now upon the European Central Bank (ECB). The ECB's refusal to purchase euro area sovereign bonds in large quantities has interesting parallels with the Federal Reserve's reluctance to buy Treasury securities in the initial years following its creation. While the past is not necessarily prologue, the evolution of the Fed's balance sheet suggests that crises can induce changes in the composition of a central bank's portfolio that would not have otherwise occurred.

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### Fed Purchases of Treasury Securities: From Unthinkable to Indispensable

In a recent speech before the Christian Democratic Union annual conference, German Chancellor Angela Merkel announced her intention "to complete the economic and currency union in Europe and, step by step, create a political union."<sup>1</sup> The comments echo recent commentary suggesting that 2011 is Europe's "Articles of Confederation moment" – the point when elected officials recognize that political union needs to be deepened if it is to be sustained. Whatever the result of the Chancellor's call for greater political integration, the U.S. offers euro area leaders a more recent and potentially constructive historical analogue for the current situation: the evolution of the Fed's balance sheet.

At the time of the Fed's creation in 1913, experts assumed that the Fed's assets would consist of short-term private sector obligations like bankers' acceptances and bills of exchange rather than government securities.<sup>2</sup> Federal Reserve acquisition of U.S. Treasury securities was viewed as "lending to the crown," a dangerous policy that could fuel inflation and compromise the independence of the central bank.<sup>3</sup> The inflation threat came from apparent monetization of debt. When the Fed buys Treasury securities, it effectively replaces interest-bearing bonds held by the public with non-interest-bearing currency. Since the Fed remits interest income (net of expenses) to the Treasury, Fed acquisition of Treasury debt effectively finances federal deficits through money creation. Direct purchases of Treasury securities was

<sup>1</sup> See: <http://www.bloomberg.com/news/2011-11-13/merkel-says-eu-must-forge-closer-union-to-convince-bondholders.html>.

<sup>2</sup> Reynolds, 1922. "Rediscount Rates, Bank Rates and Business Activity."

<sup>3</sup> Hawtrey, 1933. *The Art of Central Banking*.

also thought to compromise the Fed's independence by making the institution the Treasury's banker and main source of financing.

Treasury securities did not account for the majority of assets on the Fed's balance sheet until 1919, when the Fed was pressured by U.S. government officials to accommodate the surge in Treasury issuance to fund World War I.<sup>4</sup> Even then, the assets were not purchased outright but rather pledged as collateral by banks. Concerns about the effects of this policy remained so strong that by 1923 Treasury securities again accounted for less than half of the Fed's consolidated assets. It was not until the surge of debt issuance caused by the fiscal deficits of the Great Depression that the Fed was forced to accumulate large, direct holdings of Treasury securities. By 1934, the Fed's balance sheet consisted entirely of Treasury securities, which remained largely the case until 2008.<sup>5</sup>

The history of the Fed's shift to a Treasury-only balance sheet is of interest today for two reasons. First, the move away from private sector paper was not the result of scholarly debate but rather public finance exigencies. There is no record of a pro-Treasury cadre of theoreticians successfully convincing monetary authorities to move away from bankers' acceptances; the Fed was forced to move into Treasuries by a funding crisis. Secondly, the move to a Treasury-only balance sheet has been viewed as a spectacular success in retrospect precisely because it "minimized [the Fed's] participation in private credit markets."<sup>6</sup> The growth in Treasury debt met the Fed's growing asset needs (the equivalent of the dollar liquidity supplied to the economy). By 2001, Fed acquisition of assets other than Treasury securities was seen as tantamount to industrial policy that would allow the government to exert undue influence on the provision of credit. Within a generation, Fed actions once considered unthinkable came to be viewed as indispensable.

**Figure 1: Changes in Balance Sheets**

	Assets				Base Money			
	12/1/2006	11/1/2011	Gross Change	% Change	12/1/2006	11/1/2011	Gross Change	% Change
ECB (in €)	1,126,144	2,343,547	1,217,403	108.1%	759,800	1,232,200	472,400	62.2%
ECB (in \$)	1,493,956	3,191,974	1,698,018	113.7%	1,007,960	1,678,289	670,330	66.5%
Fed (in \$)	866,140	2,842,417	1,976,277	228.2%	838,922	2,677,758	1,838,836	219.2%

Source: Consolidated Statements of Condition

### Lessons for Italy and the ECB?

The recent spike in yields on Italian government debt has raised concerns about the sustainability of Italian public finances and the prospects for greater ECB involvement in the secondary market for euro area sovereign debt. Rather than purchase sovereign debt to change the total volume of reserves balances (as the Fed does), the ECB provides liquidity to the financial system primarily through refinancing operations and other collateralized lending to banks. The ECB also maintains large reserve positions in gold (€419.8 billion) and foreign currency assets (€228.5 billion). Although the ECB has doubled its balance sheet since 2006 to accommodate increased demand for liquidity, sovereign debt purchases through the sterilized Securities Markets Program (SMP) have accounted for only €186.8 billion of the €1.2 trillion increase in the ECB's balance sheet (about 15%).<sup>7</sup> The ECB's balance sheet growth has been much more modest than the Fed's and has not been financed through "quantitative easing," or unsterilized outright purchases of financial assets. Base money liabilities have grown at about one-fourth as rapidly as a result (see Figure 1).

As with the Federal Reserve in the 1910s of the previous century, the ECB does not seem predisposed to change the composition of its balance sheet on its own accord. The sustainability of this position may be tested by changes in the

<sup>4</sup> Marshall, 2002. "Origins of the use of Treasury Debt in Open Market Operations: Lessons for the Present."

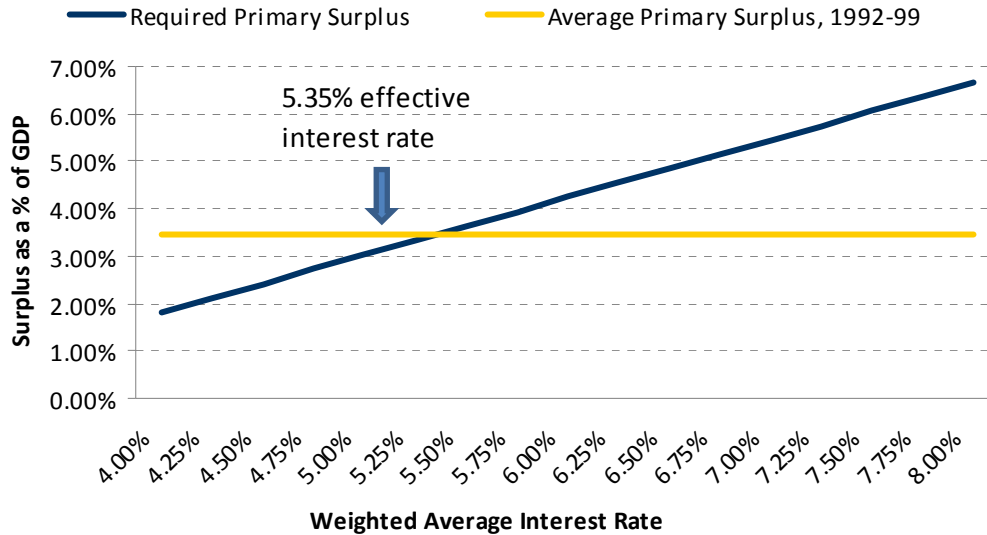
<sup>5</sup> From the onset of World War II until 1951 the Fed lost functional control over monetary policy due to its commitment to support Treasury bond prices during the War and its aftermath.

<sup>6</sup> Broadus and Goodfriend, 2001. "What Assets Should the Federal Reserve Buy."

<sup>7</sup> ECB. Sterilization refers to the collection of deposits to drain the liquidity provided through SMP purchases.

yields on Italian government bonds. The weighted average yield on government borrowing determines the size of the primary surplus (the government's budget net of interest expense) necessary to stabilize the debt-to-GDP ratio: the higher the yield, the larger the primary surplus required to achieve solvency. As shown in Figure 2, the difference between a 4.5% and 7.5% weighted average interest rate is the difference between an austere but manageable primary surplus (2.42% of GDP) and one that would be unprecedented on sustained basis (6.1% of GDP). Italy has experience with successful austerity packages in the past: from 1992 to 1999 the government ran a primary surplus that averaged 3.44% of GDP. Should Italy again succeed in achieving this level of fiscal consolidation, the average interest rate required to stabilize the debt ratio would be 5.35%.

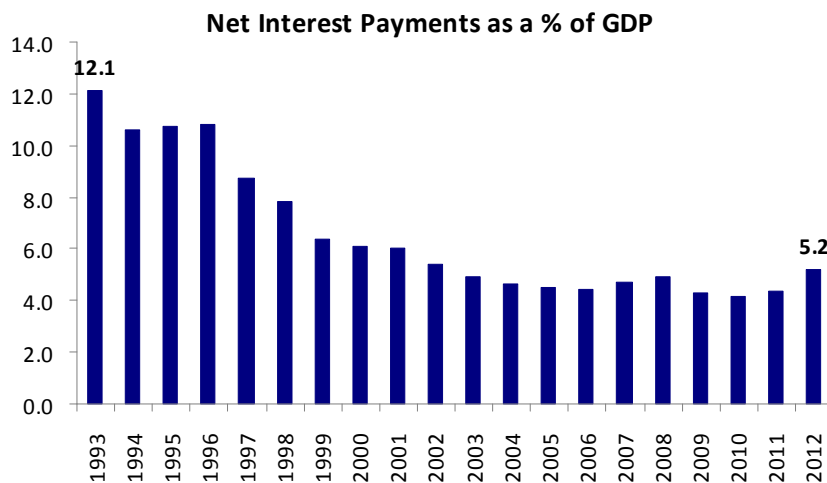
**Figure 2:**



Author's Calculations, assuming 2.5% nominal GDP growth rate

While yields (about 6.5% on 5 and 7 year notes as of November 18) are currently well above this level, these rates are only applied to the maturing portion of the debt. According to the International Monetary Fund (IMF), the average maturity of Italian government debt was 7.2 years as of March 2011, with €296 billion of the €1.9 trillion in outstanding debt scheduled to come due in 2012. This means that the 2% to 2.5% widening of yields since June will increase Italian debt service costs by about 0.5% of GDP next year. However, at an estimated 5.2% of GDP, the share of national income required to service public debt will be just two-fifths of that required in 1993 when Italy began its last sustained fiscal consolidation.

**Figure 3:**



Source: OECD and IMF

What makes the current situation more difficult relative to 1993 for Italy and other heavily indebted sovereigns is the sluggish euro area economy. Although the euro area grew faster than the U.S. economy in the twelve months ending in June 2011 and continued to expand in the third quarter of 2011, growth has clearly decelerated. Recent survey data and Carlyle internal economic indicators suggest a high probability that the euro area will enter a recession by the end of the year, if the economy has not started to contract already. Debt sustainability is nearly impossible to achieve in the context of a shrinking economy. Italian government officials must couple fiscal consolidation with clearly defined labor market reforms, a reduction in red tape, and an increase in the efficiency of the tax structure to boost labor force participation and productivity growth.

What would the ECB do if the Italian government succeeded in enacting a credible package of fiscal and structural reforms to generate primary surpluses in the range of 3% of GDP, but yields remained elevated or continued their upward trend? If the alternative is collapse of the world's third largest bond market and broader European financial system, it seems likely that the ECB would ensure the Italian government has continued access to finance at rates consistent with long-run solvency.<sup>8</sup> While such action may appear to circumscribe the bank's independence, a truly independent central bank may find itself in a lonely place when market participants recognize its liabilities (currency and reserves) are not backed by any fiscal authority.

There is a flip side to the independence coin: if a sovereign government's bonds cannot be reliably converted to hard currency at par upon maturity, then that government has no responsibility to recapitalize the central bank if it runs into problems.<sup>9</sup> A purely independent central bank lacks fiscal backing, which means its hard currency liabilities have value only to the extent that the bank maintains a positive net worth. The problem for the ECB is that its consolidated primary, secondary, and tertiary exposure to euro area government debt is already several times greater than its €81 billion in capital. For this reason, holders of euro-denominated assets are highly unlikely to view ECB independence favorably in the event of cascading losses introduced by large scale sovereign default.

## Conclusion

Modest optimism about the U.S. economy has been offset by growing concerns about seemingly intractable problems in Europe. The opposition of the ECB to large scale purchases of sovereign debt is understandable given its mandate and framework for operations. However, "independence" in this context refers not only to freedom of action but also a lack of fiscal backing. For this reason, losses arising from a large scale sovereign default could result in an existential crisis. The evolution of the Fed's balance sheet suggests that crises can induce changes in the composition of a central bank's portfolio that would not have occurred otherwise.

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<sup>8</sup> This need not involve "printing money," as existing deposit collection and fine tuning operations have allowed the ECB to provide liquidity to the financial system without undue expansion of base money, as shown in Figure 1.

<sup>9</sup> Sims, 2003. "Fiscal Aspects of Central Bank Independence."