Eurozone

Greece given an extra month to sway doubters

EU ministers set March 16 deadline

Negative reaction from markets

By Tony Barber in Brussels

Greece has earned a one-month reprieve to persuade sceptical European Union allies and financial markets that its 2010 deficit-cutting plan is sufficiently rigorous to stave off fiscal collapse.

EU finance ministers said yesterday they would wait until March 16 before deciding whether to order Athens to introduce more austerity measures, ranging from an increase in value-added tax and higher levies on energy products to cuts in capital expenditure.

Market reaction to the compromise agreed in Brussels was negative. The ASE Index, Greece's benchmark stock exchange, sank 1.7 per cent to record a third day of losses. The premium investors' demand to hold 10-year Greek government bonds rather than top-quality German Bunds rose 34 basis points to 3.39 per cent, its highest level in a week, before falling to 3.19 per cent.

"We believe the Greek government will eventually be forced to take additional tightening steps in March. This delay will probably keep uncertainty around Greek budget developments and market nervousness very high," said Giada Giani, economist at Citigroup Global Markets.

Pressure is mounting on Greece from multiple directions. The European Central Bank, the European Commission, EU national capitals and financial markets all doubt the measures outlined by Athens will slash the budget deficit to less than 3 per cent of GDP by the end of 2012, from an estimated 12.7 per cent last year.

George Papaconstantinou, Greece's finance minister, said the target was credible because his country was due to receive about €16bn ($21.7bn, £14.4bn) in EU structural funds over the next three years and an economic recovery, founded on shipping and tourism, was expected to kick in from the second half of this year.

EU finance ministers called on Greece to start implementing as early as this year "a bold and comprehensive structural reform package" covering wages, the pensions and healthcare systems, public administration, product markets, the business environment, productivity and employment growth.

They were silent on the details of a possible financial rescue operation for Athens. However, Jean-Claude Juncker, who heads the 16-strong eurozone finance ministers' group, indicated that financial assistance, if it materialised, would probably take the form of bilateral loans or guarantees from individual governments to Greece.

Mr Juncker signalled that eurozone policymakers were increasingly irritated at pressure building up on Greece in the credit default swap market, which measures the cost of insuring debt exposure but is regarded by some as a weapon used by irresponsible speculators against vulnerable governments.

"Financial markets are clearly wrong if they believe they can break Greece into little bits," Mr Juncker said. "We shouldn't accept being the target of financial markets. I am concerned by [financial markets'] irrational way of behaving."

Greece faces debt redemptions of about €20bn in April and May, a figure close to estimates in financial markets of how big a rescue package would be.

Harsh words about Greece were expressed at the finance ministers' meeting, not just by Germany and Austria, but by Sweden, a non-eurozone country. "This is quite an urgent situation. What we have seen so far is not enough," said Anders Borg, Sweden's finance minister.

Additional reporting by David Oakley in London

VIEW FROM EUROPE

The roots of the crisis show that Greece needs a reinvention not just a rescue **www.ft.com/vfe**

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Christine Lagarde of France greets Jean-Claude Juncker at yesterday's meeting Reuters

Bomber targets JPMorgan's Athens office

A bomb exploded yesterday outside the Athens office of JPMorgan, the US investment bank, **Kerin Hope writes from Athens.** Police said there was minor damage and no injuries.

The building in the central Kolonaki neighbourhood was evacuated and cordoned off after a telephone warning to a Greek newspaper. There was no immediate claim of responsibility for the blast.

Greece's socialist government last month reopened a probe into JPMorgan's sale in 2007 of a €280m structured bond to four Greek state pension funds at an inflated price.

For full report see www.ft.com/europe

Fed dissenter warns over US debt problems

By Alan Rappeport in Washington

The US must fix its growing debt problems or risk a new financial crisis, Thomas Hoenig, president of the Federal Reserve Bank of Kansas City, warned yesterday, adding a mounting deficit could spur inflation.

Mr Hoenig said that rising debt was infringing on the central bank's ability to fulfil its goals of maintaining price stability and long-term economic growth. "Stunning" deficit projections were putting political pressure on the Fed to keep interest rates low, infringing on its independence at the risk of inflation, he said.

"Without pre-emptive action, the US risks its next crisis," Mr Hoenig said in a speech at the Pew-Peterson Commission on Budget Reform.

He was the only Fed member who dissented at last month's meeting against language indicating that interest rates should remain near zero for an "extended period".

Yesterday he said that the worst option for the US was a scenario where the government "knocks on the central bank's door" and asks it to print more money. Instead, the administration must find ways to cut spending and generate revenue. He called for a "reallocation of resources" and noted that the process would be painful and politically inconvenient.

The US budget deficit is projected to be $8,000bn (€5,800bn, £5,000bn) in the next decade. Barack Obama, US president, recently lifted the government's borrowing authority to $14,300bn.

If the Fed succumbed to pressure to increase the money supply, Mr Hoenig said, inflation would lead to a loss of confidence in the dollar and in the economy. Meanwhile, a potential stalemate between the fiscal and monetary authorities that govern the economy could allow growing imbalances to go unchecked, thus raising the costs of borrowing and of capital for the US.

The hawkish Kansas Fed president also warned against "dire" consequences of the central bank prolonging its holdings of mortgage-backed securities, which it purchased in an effort to prop up the US housing market. Mr Hoenig painted a picture of a slippery slope, where a less independent Federal Reserve was asked to find ways to support other ailing sectors, such as agriculture.

The Federal Reserve is purchasing $1,250bn in MBS through March. Mr Hoenig said that it must shrink its balance sheet as quickly as possible while being careful and systematic.

Being pulled into the political framework has complicated the Fed's job, which Mr Hoenig said should remain focused on the Fed funds rate and price stability.

Holding tightly to the notion of Fed independence, he rejected a suggestion published in a paper by Olivier Blanchard, chief economist at the International Monetary Fund, that central banks should set higher inflation targets. He also said he hoped to avoid political pressure to restore quantitative easing policies.

"That's when independence will be more important than ever," he said.

Europe's central bank begins leadership overhaul

Top jobs

Vitor Constâncio's endorsement will affect the 'balance of power' in race to be president, writes Ralph Atkins

The European Central Bank has started a two-stage overhaul of its top leadership after the formal nomination of Portugal's Vitor Constâncio as its next vice-president.

Eurozone finance ministers' endorsement late on Monday of Portugal's central bank governor for the number two slot at the central bank, guardian of the euro, set the stage for a decision next year on a successor for its president, Jean-Claude Trichet.

Axel Weber, president of Germany's Bundesbank, and Mario Draghi, Italy's central bank governor, are semi-declared candidates for the top job. Mr Weber is seen by many ECB watchers as having the upper hand.

Together the appointments will mark important milestones in the ECB's 11-year history. They will shape how the bank thinks and reacts during much of this decade, when its role will expand beyond monetary policy and into financial market surveillance.

Under Mr Trichet the ECB has won praise for its handling of the global financial and economic crisis, dispelling fears that its "consensus-based" decision-making would make it slow to react.

"The question now, as the ECB moves from its infancy into its 'grown-up' years, is whether you could have less decision-making by consensus and a more robust debate," says Elga Bartsch, European economist at Morgan Stanley. "On the other hand, in the current environment with the crisis over Greece's public finances, you might want a more consensus figure."

In selecting Mr Constâncio, 66, the finance ministers opted for an economist with frontline political experience to take over from Lucas Papademos, the highly regarded academic who steps down as vice-president in June when his eight-year, non-renewable term expires.

Three years as leader of Portugal's centre-left Socialist party in the late 1980s, when he lost a general election, showed Mr Constâncio ill at ease in the belligerent world of party politics.

But that background could prove valuable, given he will almost certainly assume responsibility at the ECB for "financial stability" issues, with a seat on Europe's planned financial stability board. Averting future financial crises will probably require faster thinking than traditional monetary policy. As such, the affable but discreet Mr Constâncio could prove a valuable ally for Mr Trichet.

In turn, Mr Constâncio's appointment – still subject to formal approval by eurozone leaders – will affect the "balance of power" considerations when Mr Trichet's successor is chosen.

> Axel Weber, another former academic, is not afraid of voicing conservative views

Although the ECB is still young, a convention has arisen whereby its top posts are split between small and large countries, southern and northern Europeans, and, to a lesser extent, between "hawks" and "doves".

Regarded as a "dove" in ECB terms, less likely to worry about inflation when growth is weak, and from a southern European country, Mr Constâncio's selection appears to have strengthened the hand of a northern conservative for the top job – that is, Germany's Mr Weber.

A potential hitch is that the ECB's six-man executive board already includes a German, Jürgen Stark, who heads the central bank's economics department. One possible scenario is that Berlin might move Mr Stark to the Bundesbank, allowing France to appoint someone to take his ECB job as the quid pro quo for supporting Mr Weber as president.

But Mr Weber's appointment is not a foregone conclusion. A German heading an ECB based in Frankfurt might be difficult to accept for other eurozone governments.

Moreover, Mr Weber, another former academic economist, is not afraid of voicing tough conservative views, although he might simply be playing the role required of a central banker in Germany.

Meanwhile, Mr Draghi may have been stressing his "hawkish" credentials behind the scenes. The Italian central bank chief also has time on his side.

Ken Wattret, European economist at BNP Paribas, said that in the eurozone "the early front runner does not always end up winning the race".

Additional reporting by Peter Wise in Lisbon

IN-DEPTH ANALYSIS

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EU regulator backs rules on bonuses

By Nikki Tait in Brussels

Binding rules on pay and bonuses across Europe's banks and financial institutions would cut risks in the sector, the European Union's new top regulator told finance ministers yesterday, as he warned Brussels might impose regulations to make management boards stronger and more independent.

Michel Barnier, who last week took over as EU internal market commissioner, said control of financial institutions – including remuneration – was one of his key priorities as he begins his five-year term.

"I'm convinced that, if we want to prevent future crisis, financial institutions themselves . . . need to change. We need stronger corporate governance," he told ministers.

Brussels, he said, might need to consider "targeted measures" to strengthen the independence of boards and look at the roles played by shareholders and external auditors.

The French politician indicated his preference for tougher pay rules in the EU: "I'm convinced that binding rules on remuneration . . . would be an incentive for taking less risk."

The warnings came as the commissioner – whose wide-ranging portfolio gives him a powerful role in determining rules for Europe's financial services industry – briefed ministers on a long list of legislative plans.

Other proposals included changes to the bank capital rules; measures to increase standardisation and centralised clearing of over-the-counter derivatives; and a clampdown on tax havens.

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ECB study shows loan rejections rising

Fresh doubt over recovery's strength

By Ralph Atkins in Frankfurt

Difficulties in obtaining finance have intensified for small and medium-sized businesses in the eurozone, according to a survey that casts fresh doubt on the strength of the recovery in the 16-country region.

Rejections of bank loan applications rose significantly in the second half of last year compared with the previous six months, a European Central Bank survey of small and medium-sized businesses (SMEs) showed, with Spanish companies worst hit. Access to finance was also cited as their most pressing problem by 19 per cent of those surveyed – up from 17 per cent previously.

The results add to evidence that a weakened banking sector is constraining economic growth, with the effects of the global financial crisis still feeding through into individual bank lending decisions. The larger role played by bank loans in the eurozone, especially for SMEs that cannot raise funds from capital markets, makes the region more vulnerable than the US to a loan drought.

There are also further signs that the economic recovery is losing momentum. Germany's ZEW institute reported its "economic sentiment" indicator for Europe's largest economy had declined for a fifth consecutive month.

However, at 45.1 in February, down from 47.2 in January, the ZEW index – regarded as a useful indicator of likely trends in economic activity – was still significantly higher than its historical average.

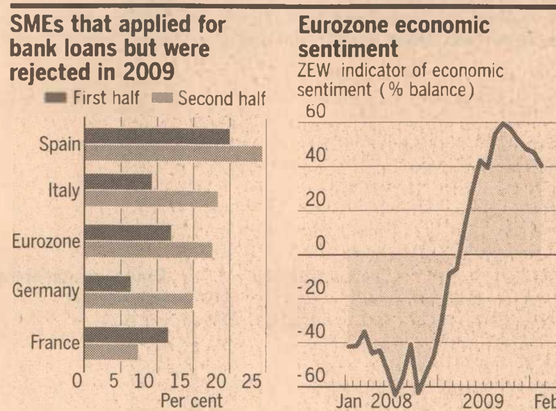
"Although we have passed through the deepest valleys of the depression, worries about the labour market, budget deficits and the euro have not lessened," said Wolfgang Franz, ZEW president.

Last week gross domestic product data showed the eurozone economy expanded by just 0.1 per cent in the fourth quarter of last year, with Germany stagnating. Looking ahead, German economic activity could "move sideways, with only minor ups and downs", Mr Franz added.

The ECB launched its survey of financing conditions facing SMEs in September. After the first survey, Jean-Claude Trichet, bank president, seized on results – showing that, in the first half of last year, 77 per cent of SMEs had received in full or partly the bank loans they had sought – as a sign that credit was continuing to flow into the real economy. But in the final six months that figure deteriorated to 75 per cent.

Moreover, the share of SMEs saying bank loans had been rejected rose from 12 per cent to 18 per cent.

Among the large eurozone countries, the rejection rate for bank loan applications deteriorated from 6 per cent to 15 per cent in Germany and from 9 per cent to 18 per cent in Italy. But the rate was highest in Spain, where it rose from 20 per cent to 25 per cent. In France, the rejection rate fell from 12 per cent to 7 per cent.



Source: European Central Bank; Thomson Reuters Datastream

January surge in UK inflation

The ending of a temporary reduction in value added tax led to a surge in the UK inflation rate last month, **Norma Cohen writes.**

CPI inflation, the measure most closely watched by the Bank of England's interest rate-setting monetary policy committee, climbed to 3.5 per cent year on year, from the 2.9 per cent annual rate recorded in December, the Office for National Statistics said.

Economists' comments that the rise was generally in line with forecasts offered some reassurance to the markets that the increase is temporary.

The governor of the bank has written an explanatory letter to Alistair Darling, chancellor, which he is obliged to do when CPI tops 3 per cent.

In addition to the reversion of VAT rates, a rise in the price of crude oil contributed to the surge in inflation.

True and fair values can melt under a spotlight

John Kay

I never imagined that mark-to-market accounting would be the theme of a sell-out musical comedy. Or that actors would audition for parts as special purpose vehicles on the West End stage. But if you beg, borrow or steal a ticket for *Enron* at the Noël Coward theatre in London's West End, you will discover that the financial crisis has made a topic that was once a guaranteed conversation-stopper the talk of the town.

For centuries the accounting principle was that gain should be recognised only when realised. Like most economists, I favoured the shift to mark-to-market principles. The older approach is objective and seems conservative, but the price of its objectivity is to mislead. Often it is fortuitous which gains are realised and which are not. If it is not fortuitous – if institutions can decide which gains to realise and which not – then a principle that appears conservative may in practice prove just the opposite. Any alternative to universal mark-to-marketing accounting gives *carte blanche* to creative finance directors.

And yet I realised that I did not apply mark-to-market principles in my own life. Like most homeowners, I would pass the windows of the local estate agents and take a surreptitious look at the prices of houses that resembled my own. This information was of no operational value to me since I did not plan to sell. There probably was a price at which I would have considered selling. But, like most homeowners, I

> **There are no right or wrong answers. No accounting principles, however wide, will cover all conceivable situations**

like the house I live in, have invested love and money in it, and would feel cheated if forced to sell it for the market price. Since I would, in any event, plan to live in a house of similar quality, I have an implicit liability, which more or less corresponds to the value of my house, whatever that may be. Still, the market price is of real interest to my creditors, which is why, when I remortgaged the house – not recently – I willingly paid for a valuation that was of no real interest to me.

I have, however, felt more convinced of the virtues of mark-to-market accounting since hearing how banks applied identical arguments to toxic assets on their balance sheets. They suggested that the contribution to capital adequacy of toxic assets should reflect their cost, or the banks' own assessment of their value, rather than the judgment of a sceptical marketplace.

Presumably, like a homeowner, they liked the assets they held, they would have felt cheated if forced to sell for the market price and, if deprived of these tasty investments, would have filled their books with others of similar quality. Whatever their beliefs or intentions, however, the obvious difference is that capital adequacy is not calculated for a bank's operational purposes, but for the protection of a bank's creditors.

At other times, market values are flattering. *Enron*, the musical, begins with the US energy trader's (now jailed) president Jeff Skilling holding a champagne party with his colleagues. Not to celebrate a deal, or a promotion, or to toast Enron's ever rising share price: but to recognise the arrival of a letter from the Securities and Exchange Commission approving the wider use of mark-to-market accounting in Enron's business.

The attraction of mark-to-market accounting for Mr Skilling was that it allowed his good ideas to be reported in accounting profits straightaway: there was no need to wait for these good ideas to come to fruition. But the proponents of good ideas are often prone to an optimistic assessment of how good the idea is. And even the most robust of auditors, which in the modern world is not very robust, is ill-placed to make an assessment.

We are dealing with questions to which there are no right or wrong answers. The true and fair view is subjective, and no accounting principles, however extensive, can cover all conceivable situations. The appropriate measure always depends on the purpose for which accounts are properly to be used. The only certainty, however, is that these proper purposes do not include flattering the egos of corporate executives or enabling banks to take deposits on false pretences.

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The Chinese tiger shows its claws

David Shambaugh

In recent months Beijing has been cracking down at home and lashing out abroad. China watchers are perplexed about the origins and implications of the new assertiveness. Many believe a threshold has been breached and that China is going to become more difficult to deal with. Others see merely the 30-year pattern of *fang* and *shou*, opening and closing, in which one step back is followed by two steps forward.

Since the adoption of a fairly progressive decision on intra-party democracy at September's plenary session of the Chinese Communist Party Central Committee, political reforms have stalled. The foreign business climate has also deteriorated badly, with multinationals complaining of a host of new operating constraints and protectionist measures. Some western executives with long experience in China say it is the worst they have seen since 1989-92. Meanwhile, the country's trade and currency surpluses continue to balloon.

In October the world witnessed a powerful military parade displaying the People's Liberation Army's new advanced weapons. This was followed by heavy-handed Chinese management and censorship of President Barrack Obama's visit to China in November. In December, China effectively blunted pressure for binding and verifiable climate control measures at the Copenhagen summit; dissident Liu Xiaobo was sentenced to 11 years in prison; and the (perhaps unwitting) British heroin smuggler Akmal Shaikh was executed, despite dozens of high-level entreaties by the British government.

Since the beginning of the year, Sino-American relations have been buffeted by Google's complaints of cyber-hacking, arms sales to Taiwan, US complaints about the strength of the renminbi, and China's blocking of further sanctions against Iran's nuclear programme. Bilateral military exchanges have been suspended and the rhetoric is ratcheting up daily.

It is not over: Mr Obama will meet the Dalai Lama in Washington tomorrow, which will trigger renewed Chinese fury and further suspension of bilateral exchanges. More Chinese dissidents have recently been sentenced to lengthy jail terms, and the two countries are preparing to exchange a series of retaliatory trade tariffs and anti-dumping duties.

The US is not the only country having difficulties with China. The European Union has a variety of complaints. India-China relations are also in a bad patch over border disputes and the activities of the Dalai Lama. Some south-east Asian nations are disconcerted by China's newly assertive attitude on several regional issues. China and several Latin American countries are experiencing trade and economic frictions. There is a growing backlash against Chinese resource extractions in Africa. Australian-Chinese relations are still strained by the Rio Tinto-Chinalco deal that went sour last summer, and by the subsequent arrests and pending trials of Rio staff in China. Even Russia – China's vaunted strategic partner – has grievances over trade, immigration and arms sales.

On all these issues, China's government spokesmen and officials have adopted a tough and uncompromising attitude. In several sets of ongoing bilateral negotiations, foreign diplomats in Beijing report a new truculence and unwillingness to compromise on China's part. Meanwhile, Chinese think-tank analysts seem oblivious to the dramatic downturn in their country's reputation. Global opinion

> **Those who have argued that Beijing is moving inexorably towards greater openness are beginning to think again**

polls on China have been generally negative (except in Africa) since 2008, but are now sinking lower.

So what is going on? Conservatives in the west argue that we are merely seeing the true colours of an aggrieved rising power that wishes to challenge the status quo. Many Chinese commentators point instead to a western-triggered global financial crisis that has vindicated China's development model and given it new confidence. Meanwhile, analysts who have argued that the country is moving inexorably towards greater openness and reform are beginning to re-examine long-held assumptions.

Alternative explanations also exist, which are not mutually exclusive. One is that a leadership transition is under way in the run-up to the 2012 Party Congress, and that during such periods China becomes more caustic while candidate leaders try to prove their nationalist credentials. A related hypothesis is that China's rulers believe the country is beset by numerous socio-economic problems and feel their rule is fragile – thus they divert attention with nationalistic rhetoric.

Another interpretation is bureaucratic: that the security services and conservative party factions have trumped reformers and are trying to exert renewed authoritarian control over several policy spheres. Others believe that China's foreign policy "realists" have won a long-running debate about China's international posture and that those in favour of multilateralism and international co-operation are in eclipse (the realists argue that China should protect its own narrow national interests). Then there are those who hold that China's "netizens" and hyper-nationalist citizens are pushing the government to be tougher internationally – especially vis-à-vis the US.

There is some truth in each of these explanations. The Year of the Tiger is known to be turbulent, and it is beginning true to tradition.

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Let Greece take a holiday from the eurozone

Martin Feldstein

Loan guarantees or temporary credits from Germany and France may allow Greece to avoid a refunding crisis later this spring. But temporary financial patches will not deal with the real problem: Greece's budget deficit of 13 per cent of gross domestic product. To prevent an exploding ratio of government debt to GDP, Greece needs to cut future annual spending and increase its future taxes in a combination equivalent to at least 10 per cent of GDP.

Unfortunately, such a fiscal contraction would sharply increase unemployment, already at a painful 10 per cent; and political opposition makes such action impossible.

If Greece still had its own currency, it could, in parallel, devalue the drachma to reduce imports and raise exports, cutting the 15 per cent of GDP trade deficit. The level of Greek GDP and employment might then actually increase if the rise in exports and decline in imports added more to domestic employment and output than was lost through raising taxes and cutting government spending. But since Greece no longer has its own currency, it is not free to follow this strategy.

So what can Greece do? It can simply raise taxes and cut spending, asking its population to suffer many years of high unemployment. Or it can seek a real bail-out from its euro partners, in which they give the Greek government enough money year after year to pay its bills without raising taxes. Even if the small size of the Greek economy made that feasible, it would be rejected because Germany and France would correctly fear that doing so would lead to pressure for similar bail-outs from larger eurozone countries. Another option is for

> **It could take a leave of absence with the right and obligation to return at a more competitive exchange rate**

Greece to secede from the eurozone, perhaps starting a process in which other eurozone countries with large fiscal and trade deficits also drop out.

None of the above choices appeals to Greece or its eurozone partners. But there is a better idea that could preserve the single currency while helping the beleaguered country to adjust its twin deficits.

The rest of the eurozone could allow Greece to take a temporary leave of absence with the right and the obligation to return at a more competitive exchange rate.

More specifically, Greece would shift its currency from the euro to the drachma, with an initial exchange rate of one euro to one drachma. Bank balances and obligations would remain in euros. Wages and prices would be set in drachma.

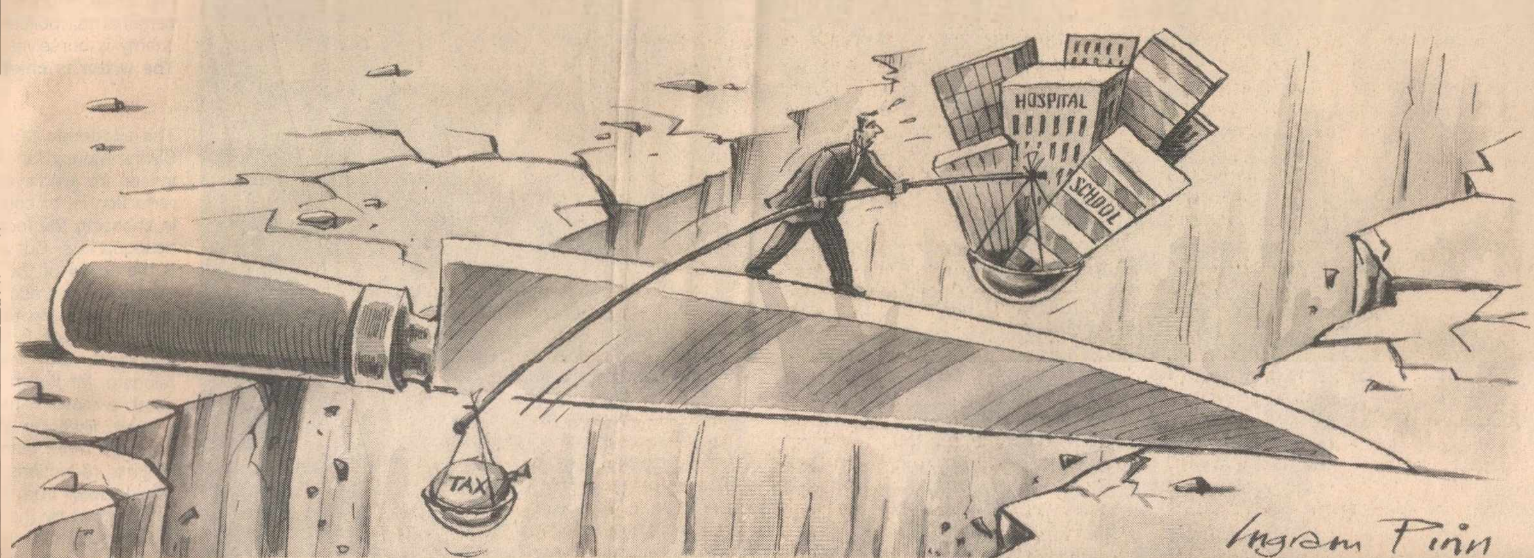
If the agreement called for Greece to return at an exchange rate of 1.3 drachmas per euro, the Greek currency would immediately fall by about 30 per cent relative to the euro and other non-euro currencies. If there is little or no induced inflation in Greece, Greek products would be substantially more competitive in both domestic and foreign markets.

In exchange for permission to reset its exchange rate, Greece would have to agree to tough fiscal measures to bring its budget deficit down quickly and keep it down. Although the higher cost of imports would cut local real incomes, damage would be limited by the fact that imports are less than 20 per cent of total Greek GDP.

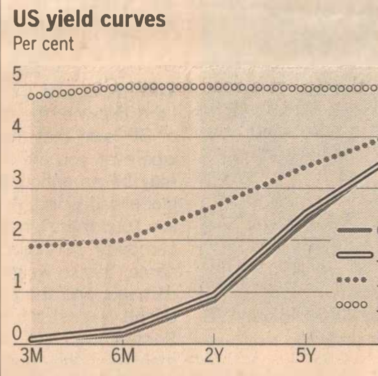
Other eurozone members might object to giving Greece this improved competitiveness. They might worry that other countries with large trade deficits would press for a similar deal. But allowing Greece to reset its exchange rate might still be better than having the country permanently leave the eurozone. It would certainly be better than condemning the Greek people to a decade of suffering. It would also be better than Germany and other countries providing continual financial assistance to Greece, since such a process might make Germany itself want to quit the eurozone.

The European economic and monetary union is doubly flawed. First, it forces diverse countries to live with a single interest rate and exchange rate that cannot be appropriate for all members. Second, combining a single currency with independent national budget policies encourages fiscal profligacy. The Greek situation is a manifestation of these flaws. If European political leaders nevertheless want to preserve the current system, allowing a temporary exchange rate reset for Greece may be the best option.

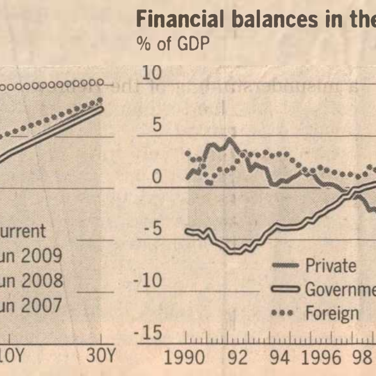
The writer is professor of economics at Harvard and president emeritus of the National Bureau of Economic Research. He chaired the Council of Economic Advisers under President Reagan and is a member of President Obama's Economic Recovery Advisory Board



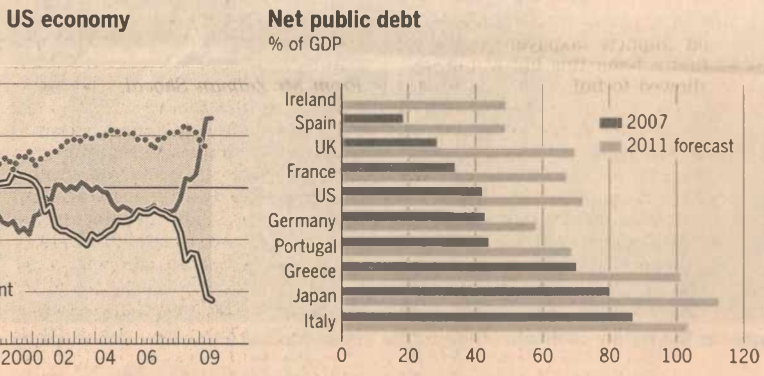
US yield curves
Per cent



Financial balances in the US economy
% of GDP

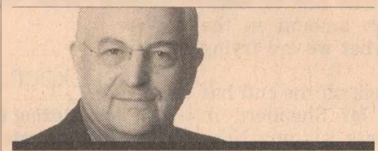


Net public debt
% of GDP



Sources: Bloomberg, BEA, OECD

How to walk the fiscal tightrope that lies before us



Martin Wolf

Niall Ferguson is not given to understatement. So I was not surprised by the claim last week that the US will face a Greek crisis. I promptly dismissed this as hysteria. Like many other high-income countries, the US is indeed walking a fiscal tightrope. But the dangers are excessive looseness in the long run and excessive tightness in the short run. It is a dilemma of which Prof Ferguson seems unaware.

Prof Ferguson stated that, according to the White House projections, gross federal debt will exceed 100 per cent of gross domestic product by 2012; that the US is forecast never to run a balanced budget again; that monetary policy, not deficits, saved the economy; that higher interest rates are on the way; and, not least, that high fiscal debt is damaging.

Brad DeLong of the University of California, Berkeley, responded that parts of this argument are wrong or misleading: White House projections are for federal debt held by the public to be 71 per cent of GDP in 2012 and not to exceed 77 per cent by 2020; monetary policy would not have delivered even the limited recovery we have had on its own; and higher interest rates may indeed be on the way, but there is nothing in current yield curves to suggest it. Moreover, there is no reason to balance budgets in a country whose nominal GDP grows at up to 5 per cent a year in normal times.

Prof Ferguson is trying to frighten US policymakers out of sustaining or, better still, increasing fiscal stimulus, even though the true issue is longer-term sustainability. He also accuses opponents of believing in a "Keynesian free lunch". Not so. The argument is, rather, that the benefits of the higher output today exceed the costs of debt service tomorrow.

Prof Ferguson believes instead in a conservative free lunch. This is the view that fiscal tightening today would have little effect on activity. Normally, when monetary policy has room for manoeuvre and the private sector's borrowing is unconstrained, that is right. But, as Olivier Blanchard, chief economist of the International Monetary Fund, and colleagues note in a recent report: "To the extent that monetary policy, including credit and quantitative easing, had largely reached its limits, policymakers had little choice but to rely on fiscal policy."

The high-income countries that have experienced the biggest jumps in deficits and debts have, inevitably, been Ireland, Spain, the UK and US, as Stephen Cecchetti and colleagues at the Bank for International Settlements pointed out in "The Future of Public Debt", a paper presented last week at a conference celebrating the 75th birthday of the Reserve Bank of India. These are the countries that had the biggest credit booms and asset bubbles. It is there, as a result, that private-sector spending has been most constrained by the pressure to deleverage.

Jumps in fiscal deficits are the mirror image of retrenchment by battered private sectors. In the US, the financial balance of the private sector (the gap between income and expenditure) shifted from minus 2.1 per cent of GDP in the fourth quarter of 2007 to plus 6.7 per cent in the third quarter of 2009, a swing of 8.8 per cent of GDP (see chart). This massive swing occurred *despite* the Federal Reserve's efforts to sustain lending and spending. Similar shifts occurred in other crisis-hit countries.

If these governments had decided to balance their budgets, as many conservatives demand, two possible outcomes can be envisaged: the plausible one is that we would now be in the Great Depression redux; the fanciful one is that, despite huge increases in taxation or vast cuts in spending, the private sector would have borrowed and spent as if no crisis at all had happened. In other words, a massive fiscal tightening would actually expand the economy. This is to believe in magic.

The huge increases in fiscal deficits were appropriate to the circumstances. The only way to have avoided them would have been to prevent prior expansions of private credit and debt. But Prof Ferguson is right: everybody knows that such

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deficits cannot continue indefinitely. As Carmen Reinhart and Kenneth Rogoff point out in a recent paper, once ratios of public debt to GDP exceed 90 per cent, median growth rates fall by 1 per cent a year. That would be costly. Moreover, there is a risk that, at some point, confidence would be lost and interest rates would soar, with dire impact on debt dynamics.

The difficulty, however, is that, as the McKinsey Global Institute has also noted in a recent report: "Historic deleveraging episodes have been painful, on average lasting six to seven years and reducing the ratio of debt to GDP by 25 per cent". The only ways to accelerate this would be via mass bankruptcy or inflation. If these are ruled out, what might support demand, while deleveraging continued? If fiscal policy is also ruled out, the only option would be foreign demand. But who is likely to offset contracting demand in the US and other hard-hit economies? Nobody, alas, is the answer.

Yet, as the BIS paper also noted, long-run fiscal prospects, largely driven by ageing, are dire. Projecting forward from the dreadful starting points, the BIS authors argue that ratios of public debt to GDP could reach 250 per cent of GDP in Italy by 2050, 300 per cent in Germany, 400 per cent in France, 450 per cent in the US, 500 per cent in the UK and 600 per cent in Japan. If the sovereign debts of high-income countries are not to be reduced to junk, these countries do, indeed need credible plans for retrenchment. On this there is no disagreement. The best approach would be sharp reductions in long-term growth of entitlement spending. Furthermore, as economies recover, short-term fiscal action will be needed. Actions will have to include spending cuts and increases in tax, to restore revenue lost forever in the crisis.

Now we come to the big dilemma: what if private deleveraging and fiscal deficits continue in the US and elsewhere for years, as they did in Japan? Then triple A-rated countries, including even the US, might lose all fiscal headroom. This has not yet happened to Japan. But it could.

So, yes, high-income countries face huge fiscal challenges. And yes, the crisis-hit countries start from grossly unsustainable fiscal positions. But the US is not Greece. Moreover, a massive fiscal tightening today would be a grave error. There is a huge risk – in my view, a certainty – that this would tip much of the world back into recession. The private sector must heal. That, not fiscal retrenchment, is the priority.

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