

# Sovereign Credit Risk in the Eurozone

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## Introduction

The roots of the Euro area crisis can be traced back to at least the summer of 2007. Although not picked up by the credit rating agencies until much later, the probability of default on sovereign debt increased in parallel with clear macroeconomic misalignments. These misalignments include recession-triggered budget deficits, bailout-motivated fiscal measures,<sup>1</sup> as well as country-specific strategies and political risks – i.e. in the case of Portugal, Italy, Ireland, Greece and Spain.<sup>2</sup> In the absence of a major restructuring of debt, sovereign credit risk adjustment in these countries can be achieved only through economic growth or an alternative process of financial austerity and/or inflation.

Even at the eleventh hour, when looked at externally, various measures can still be taken to reduce sovereign default probability within the Eurozone. In Italy and Spain, for example, better sovereign credit risk rating might still be restored by the new government teams in power raising tax rates or/and reducing government purchases. Greece can do more to inflate away the real cost of sovereign debt via either more business/corporate activity, higher economic growth and/or a bailout. While the trade-off between

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<sup>1</sup> See Haidar (2009a) for the case of the United States.

<sup>2</sup> These five countries are referred to as the South-West Eurozone Periphery (SWEAP).



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pros and cons of these policy tools and choices varies across space (countries) and time, such trade-off assessment is not always straightforward.

The institutional capacities and legal frontiers within the Eurozone countries, especially the constraints due to membership, have complicated any assessments of such hard politically influential measures in times of rising bond market pressures due to rising default probability. Nevertheless, any one of the current 17 Eurozone members – whether with high default probability or equipped with budget challenges – is in better position to receive support as a member compared to a non-member

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even when equipped with an independent monetary policy in addition to full fiscal sovereignty. The economic crisis in Hungary is a case in point, with the country facing

pressure from both the IMF and the European Union concerning constitutional amendments that would affect both the independence of the country’s central bank and the flexibility of fiscal policy.

The most creative solution for the Eurozone to face rising sovereign default probabilities across some of its member countries in order to escape from the current crisis is to adjust its design to include a ‘minimal fiscal Europe’. In this case the accord reached in Brussels in December 2011 would appear to be a step in the right direction and would raise further the protective status offered to the bonds of Eurozone countries over non-members. The multi-state fiscal agreement would curb structural deficits at 0.5% of GDP and require each country to establish an ‘automatic correction mechanism’ when budgets overshoot the target. The agreement is expected to produce a procedure to discipline prodigal countries, with some controls over taxation and expenditure on governments that exceed the public-sector deficit limit of 3% of GDP.

## **Eurozone fiscal shape and imbalances origin**

Which European Union countries are in sound financial-fiscal form? And which are not? In 2010, gross debt as a percentage of GDP within the 17 countries using the euro rose to 85.4% of GDP from 79.8% the year before. For the 27 countries comprising the European Union, gross debt as a percentage of GDP stood at 80.2% last year, but gross debt (as a percentage

of 2010 GDP) is less than 50% in 12 countries.<sup>3</sup> However, it is higher than 110% in Greece and Italy, and budget balance figures follow the same trend. The reasons are not technically mysterious.

The sovereign debt default risk in the euro area originates from several causes. First, the fiscal expenses of the financial crisis – i.e. fiscal intervention measures (such as bank bailouts) – enhanced the short-term financial outlook but created more pressures on sovereign debt service. Second, the fiscal revenues decreased due to changes in real estate markets and the deflation of asset bubbles, as well as soaring structural public-sector deficits. Third, the economic recession decreased various fiscal revenues between autumn 2008 and late 2010, and increased significant government expenditures (i.e. unemployment benefits) for the typical cyclical reasons. These three factors, among others,<sup>4</sup> caused sovereign credit risk to deteriorate recently in the euro area. In some countries, i.e. Greece, additional factors came into play where serious problems with the transparency and accuracy of economic data led to a rapid rise in bond yields, leading to delayed sovereign debt downgrades, which significantly raised the probability of default. The role of poor economic data in this process has been explored by Sturgess (2010).

On the political risk front, in autumn 2009, the new Greek government, then, realised that the fiscal deficit was more than double (12.7%) what was reported (6%) of GDP by the leaving government and more than the figure (3.7%) promised to the European Commission by early 2009. Also, Eurostat's number for the same year for Greece was 13.6%. In addition, the fiscal revenues drop due to the economic crisis deteriorated Greece's sovereign debt credit rating and pushed Greece to a larger budget deficit. Various reasons are behind the Greek budget misbalance: weak tax administration, an over-large public sector and age-related expenditures are key reasons. A lack of industrial competitiveness – i.e. measured by the World Bank's *Doing Business 2012* report and the World Economic Forum's *Global Competitiveness Report 2010* – all show the poor relative position of Greece.<sup>5</sup> Portugal, Italy and Spain are not much better in terms of economic structure and institutional obstacles.<sup>6</sup>

<sup>3</sup> These were Bulgaria, the Czech Republic, Denmark, Estonia, Finland, Latvia, Lithuania, Luxembourg, Romania, Slovak Republic, Slovenia and Sweden.

<sup>4</sup> For instance, Haidar (2012) explores how a currency crisis can transmit through the international trade channel.

<sup>5</sup> See <http://www.doingbusiness.org/-/media/FPDKM/Doing%20Business/Documents/Annual-Reports/English/DB12-FullReport.pdf>.

<sup>6</sup> Haidar (2009b) shows how investor protections increase and speed up economic growth.

## **Global fiscal outlook: is the Eurozone really different?**

On the developed economies scene, not only Eurozone members face potential trouble when it comes to sovereign debt default probability, credit risk and weak economic growth. High budget deficits are not peculiar to the Eurozone area; in fact, the United States and the United Kingdom are running higher structural budget deficits than Greece, Portugal and Spain. Furthermore, sovereign debt-to-GDP ratios in these two countries are close to, or over by some definitions, the 90% level, which imposes a negative effect on the real GDP growth rate, according to Reinhart and Rogoff (2010).

Most developed countries faced declining budget positions, especially when compared with emerging economies over the period (Q3, 2007 to Q1, 2011). According to the IMF (2010), out of all emerging economies, India is the only one with relatively high budget deficit. However, it appears to be well positioned to handle its 10% public-sector budget deficit and 80% sovereign debt-to-GDP ratio given its high income growth rate in national income, although there are some concerns about the future. However, India is protected from bond market pressures since most of the country's sovereign debt is denominated in Indian rupee as well as being held by domestic buyers. Nevertheless, India's potential challenge, from this angle, is that its sovereign debt is purchased by its domestic financial sector, which is still subject to many restrictions and is currently less integrated into global financial markets given capital controls. Needless to say, if India's fiscal deficit is not reduced, the economy may be at a higher credit risk because India is highly vulnerable to a potential decline in its GDP growth. Still, it looks spectacular, given the past, that emerging market economies are almost absent from any list of sovereign indebted countries with budget concerns. Furthermore, most emerging market economies take credit for the robust state of their public finances.

## **Did the Stability and Growth Pact affect sovereign default risk?**

Each of Portugal, Italy, Ireland, Greece and Spain faced high spreads compared to the German Bund yield on their ten-year sovereign bond yields before the creation of the Eurozone in early 1999. These spreads indicate

inflation and currency depreciation expectations in these countries during that era; each of these economies could look to an inflationary option with associated forecasts of currency depreciation vis-à-vis the (former) Deutschmark to resolve unsustainable budget matters. However, the creation of the Eurozone excluded this option as, then, each of these countries changed to have neither an independent currency nor an independent central bank to stabilise inflation.

Did markets buy the idea that a Eurozone membership would improve fiscal outlook? Yes, but this belief proved to be false and it overestimated the power of the Stability and Growth Pact (SGP) to facilitate the job of budgetary-behaving Eurozone members to discipline the budgetary-misbehaving peers. Furthermore, the de facto sovereign debt risk pooling expectations among Eurozone members – via fiscal transfers or ECB bailouts – was misplaced. According to Buitert and Sibert (2006), between the first quarter of 1999 and the third quarter of 2007 (for Greece between 2001 and 2007, given that it joined the Eurozone in 2001), the sovereign spreads decreased significantly (to around 20 basis points) for Portugal, Italy, Ireland, Greece and Spain over the Bund yield. The recent sovereign credit crisis revealed that the key drivers of (presence or absence of) budget balance did not much change. However, the sovereign spreads of Portugal, Italy, Ireland, Greece and Spain increased again, but the crisis shows us that this increase is due to sovereign default risk and not to currency valuation expectations or inflation forecasts.

### **How can the EU solve the Eurozone fiscal crisis and reduce sovereign default probability?**

Given the current political economy of the Eurozone area, the sovereign debt of the five South-West Eurozone Periphery (SWEAP) countries can be reduced only via five channels:

1. bailout
2. higher growth
3. lower interest rate
4. budget cuts
5. default.

While the default option is the most challenging to do, the bailout is technically easiest, but politically the most difficult option. A bailout can happen via two paths from abroad: current transfer payment or capital transfer payment. On the other front, various forms of debt contract non-compliance actions can lead to a default. These forms may include sovereign debt restructuring, interest or principal repayment rescheduling, contract repudiation, standstill or moratorium.

Economic growth, in theory, is a variable that affects sovereign debt reduction. However, economic growth is not a policy tool. Furthermore, the Eurozone economic growth rate looks to be relatively weak in the near future according to the recent World Bank Development Economics Prospects Group (World Bank 2010), and all other relevant forecasts show little optimism on this front. Regardless, looking again at the post-Second World War economic era, a critical observer can easily notice that the pressure for higher spending is positively correlated with GDP growth rates, making the real effect of higher GDP growth on fiscal revenues less effective, at least when it comes to reducing sovereign debt or enhancing sovereign credit risk.

While an indebted economy may wish to have a lower debt cost (interest rate), it may not happen as interest rate reduction is not a typical policy tool when it comes to sovereign debt management and country credit risk. However, in certain cases – i.e. when the financial system is affected by policy actions (as currently in the Eurozone) – the interest rate tool can be used by the European Central Bank to intervene in the SWEAP ongoing case. For instance, banks and other financial institutions may be pushed – not by macroeconomic prudential consideration – to hold sovereign debt, and the ECB may enforce capital controls.

A feasible (and very valid in this case) policy tool is budget cuts (or tax rises). In the current case of the Eurozone, fiscal policy may well be utilised as a key tool to address the ongoing budget deficits and sovereign default potential. It is, understandably, a politically hard step to take given its relatively low popularity. The trick in the Eurozone scenario is the pressure of public institutions – even if there is a public agreement on budget burden and the need to address it efficiently and effectively, political parties (especially incumbents) may be less able or equipped to take such decision.

## How did the European Stabilization Mechanism help SWEAP attract better credit rating?

The SWEAP sovereign debt obstacles included higher than 10% yields on the relevant countries' sovereign debts in Q4 2010, more than 800 basis points on five-year sovereign credit default swaps, as well as a legitimate doubt about the SWEAP's access to financial markets (given their relatively low willingness) to finance SWEAP's resulting sovereign funding shortage of more than €100 billion (up to March 2011). In parallel, spreads versus Bunds on SWEAP's sovereign debts scaled up at a time when concerns were raised regarding the health of the fiscal and financial balance sheets in these countries (i.e. doubts regarding misreporting were in place – for example, for Greece (Sturgess 2010)).

The International Monetary Fund (IMF), European Central Bank (ECB) and European Union (EU) took clear steps to address the recent SWEAP sovereign debt obstacles. First, the ECB tried to prevent a new financial crisis in the Eurozone by hindering key market disruptions. It tried to eliminate sovereign debt defaults, which it perceived as unguaranteed. Various financial institutions (mainly investment banks) hold substantial portions of the sovereign debts of the budgetary-challenged Eurozone countries. The €60 billion ECB supranational fund contributed to the deviation from SWEAP's sovereign debt crisis and Eurozone financial crisis. Second, the EU and IMF provided a €110 billion bailout for Greece alone. A key goal – to block the run on the sovereign debt of Portugal, Italy, Ireland and Spain's sovereign debt – was not met by the Greek bailout. Thus, this failure pushed for a second bailout (European Stabilization Mechanism, ESM) to the rest of the Eurozone members. This bailout was partly provided by the European Financial Stability Facility (EFSF); the EU has the potential to raise up to €440 billion of intergovernmental money, as well as another €60 billion supranational facility managed by the European Commission. Moreover, the IMF made up to €250 billion available to supplement the ESM.

In early May 2010, the IMF, ECB and European Commission (EC) put together a bailout package for the SWEAP countries in three different forms: (i) a €440 billion intergovernmental facility called the EFSF; (ii) €250 billion from the IMF; and (iii) €60 billion from the EU fund, managed by the EC. Each Eurozone member country provided an amount

in proportion to its participation in ECB paid-up capital. Moreover, each Eurozone member country guaranteed more than 100% of its contribution to ESM in order to attract better (the aim was for AAA) sovereign credit risk rating. Accessing these funds requires requesting members to meet fiscal conditions (the example of the Greece deal is mentioned in the next section). In addition, the ECB undertook its own support measures.

The ECB took a surprising step as it deviated from its practice since inception as well as from how it perceives the role of an independent central bank. The ECB decided to buy sovereign debt in the secondary markets. It created a Securities Markets Program (SMP) to be able to buy private and sovereign debt in secondary markets. Does this step mean quantitative easing? No, according to the ECB, which argued that it can collect term deposits to effectively sterilise such purchases.<sup>7</sup> The ECB aimed to address dysfunctional markets and not to address sovereign liquidity. Although, in real terms, there is no substantive difference between quantitative easing and asset purchases within the SMP scheme – still the ECB argued that its motivation is not far from its financial stability mandate. However, the Greek risk remained.

The above actions were necessary from a fear of contagion perspective. The Greek sovereign debt crisis could have easily transmitted (and it did later) to a liquidity and funding crisis for other SWEAP members. Back then, none apart from the ECB could have acted to hedge the Eurozone sovereign debts at risk from a contagion-driven sudden stop and sovereign default.

## **What is the EU/IMF–Greece deal?**

Initially, the Eurozone and IMF allocated €110 billion via a three-year loan programme. The Eurozone members provided €80 billion, allocated in parallel with their relative ECB capital shares, and the IMF provided €30 billion. This programme reduces the need for Greece to access financial markets until 2012 given the relative new loan rates – 300 basis points above Euribor for variable-rate loans of maturities up to three years, 400 basis points above Euribor for variable-rate loans of maturities longer than three years, and three-month Euribor (instead of swap rate) on

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<sup>7</sup> Sterilise means exchange overnight deposits with the ECB with one-week term deposits, constituting eligible collateral for borrowing from the euro system. In other words, it is the use of offsetting open market operations to prevent an act of exchange market intervention from changing the monetary base. With sterilisation, any purchase of foreign exchange is accompanied by an equal-value sale of domestic bonds, and vice versa.

fixed-rate loans.<sup>8</sup> In return, Greece agreed to undertake reform measures. It started to implement a budget adjustment worth €30 billion until end of 2012. It aims to reduce its fiscal deficit to 3% of GDP by 2014, among other reform measures. Greece also agreed to increase its VAT rate to 23 from 21%, fuel and alcohol taxes by 10 percentage points, and to reduce various government-sector wage, pension and employment benefits. In addition to this fiscal tightening, it increased the minimum retirement age to 60 years as part of its pension system change, and is in the process of privatising a number of state-owned enterprises.

### **How feasible is a sovereign debt rescue plan in the Eurozone?**

There has been some discussion – from the ECB, Lisbon Treaty, German constitution, EC and IMF perspectives – regarding whether such a bailout is do-able from a regulatory perspective. First, the Lisbon Treaty is silent about the ability of the ECB to buy sovereign debt on secondary markets. However, the Lisbon Treaty does not allow ECB to supply credit or buy sovereign debt from sovereigns. Thus, the action of the ECB does not violate the Treaty, although it may not conform to its spirit. Second, there has been debate regarding whether the constitution of Germany allows such kinds of bailout. In fact, two court cases are still ongoing in Germany. On one side, there is an argument that Germany's participation in the Greek bailout would go against the principle of democracy and social state;<sup>9</sup> on another side, there is an argument for the 'no bailout clause',<sup>10</sup> pushing for hindering Germany's participation in EFSF. This paper does not aim to discuss the legal interpretation of the Lisbon Treaty; it is important, though, to mention that Article 125 of the Lisbon Treaty does not prohibit Eurozone members from guaranteeing other countries sovereign debt. Third, the IMF can, arguably, lend only to states with balance of payments (BoP) challenges, a matter that will prohibit it from bailing out Greece, as the latter has no independent BoP. However, the IMF refers to the BoP as a country's foreign transactions not as a country's foreign reserves balance, official settlements balance and monetary balance. As Greece has an obvious BoP challenge – i.e. negative external investment position doubled over the last

<sup>8</sup> Both fixed- and variable-rate loans also incur a one-off 50 basis points charge for operating expenses.

<sup>9</sup> Articles 14, 20, 23 and 28 of the Basic Law.

<sup>10</sup> Article 125 of the Lisbon Treaty.

decade from –39% of GDP in 2000 – the mandate of the IMF allows it to extend support to member countries on a short-term basis against severe financial and fiscal conditions. Fourth, from the European Commission's perspective, there should be no problem. Article 122.2 of the Lisbon Treaty says, 'Where a Member State is in difficulties or is seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences beyond its control, the Council, on a proposal from the Commission, may grant, under certain conditions, Union financial assistance to the Member State concerned ...'. Although the case of Greece would not benefit from Article 122.2, the contagion it may cause could easily lead other states to be victims of a matter beyond their control. In a nutshell, from a regulatory perspective, a sovereign debt rescue plan in the Eurozone is feasible.

### **Is there a need for structural economic reforms in the Eurozone?**

The recent credit risk crisis in the Eurozone produces key lessons for near-future sovereign debt policymaking. First, serious structural economic reforms would be needed to sustain certain fiscal adjustments. These structural reforms would include state-owned enterprises (SOEs) privatisation, employment regulatory reforms and investment climate improvements. This kind of economic reform decreases government's intervention in the economy as it will inspire job creation by the private sector and help government reduce pensions and employment payments, as well as provoke more transparent incentives and private-sector mechanisms.

Second, there is a need for further trust in the ability and willingness to restructure the maturity timing and debt contracts of sovereign debt in SWEAP. This restructuring did not happen in 2010 before the ECB and the IMF put their bailouts out. At this stage, it is harder to effect such restructuring as Eurozone creditors to SWEAP will lose. At the same time, this kind of market trust is needed mainly because the fiscal tightening in Greece may not be sustained after the new elections in 2013, and the market's fear of default may hold as valid between now and then. This fear may remain valid because, for SWEAP countries, the current trend of total sovereign debt against its exposure to toxic bank assets via the banks recapitalisation cost and remaining debt's guarantee does not help to reduce the probability of sovereign default. Cottarelli *et al.* (2010) discussed various examples of highly indebted countries. Their study

found that most economies that eliminated their relatively high sovereign debt without default were able to do so by combining higher real income growth with either inflating taxes or depreciating currency. However, this observation is not relevant to SWEAP countries as none of them runs its own monetary policy, quite apart from the fact that the probability of higher income growth in those five countries is not promising.

Third, fiscal consolidation may help SWEAP countries avoid future sovereign debt default. Negative key (current account, financial account, capital account and budget) deficits associated with relatively high sovereign debt level and above-average service cost are reason enough for a fiscal authority to announce sovereign debt default – at the cost of the level of and ability to access to international markets. The European Commission (2007), Ardagna (2004), and Alesina and Ardagna (2002) observe that lower initial fiscal deficit (as a percentage of GDP), higher initial sovereign debt (as a percentage of GDP) and past income growth decrease the probability of fiscal consolidation failure.

The SWEAP countries' cost and duration of lack of access to capital (foreign and domestic) markets will significantly depend on the depth and breadth of structural economic reforms that each of the SWEAP's governments undertakes in the near future.

### **Where does the corporate sector stand in the Eurozone credit risk framework?**

Banks from the Eurozone countries hold a large amount of the sovereign debt of SWEAP countries. Thus, a sovereign default by any SWEAP country would be expensive to other Eurozone members. For this reason, the IMF/ECB bailout did not, for instance, initially ask Greece to restructure its debt. From a financial standpoint, fiscally disciplined Eurozone countries (mainly Germany and France) would prefer to bail out SWEAP countries than their own banks, although both of these bailout options is not politically easy to exercise.

Why would fiscally disciplined Eurozone countries prefer to bail out SWEAP countries instead of their own banks? A first motivation would be to give a signal to other fiscally challenged countries that if they ask for a bailout, then they will be subject to tough (specifically fiscal) conditions. Only in the absence of tough conditions in the bailout agreement, other

countries would be more encouraged to seek bailout – in this case, bailing domestic banks (i.e. in Germany and France) would be more reasonable in economic terms. Actually, among other reasons, the tough conditions, i.e. on Greece, made Spain avoid asking for a similar bailout. A second motivation would be to reduce the risk associated with a sovereign debt default by decreasing the risk associated with creating an extreme concentration in the Eurozone banks. Technically, bailing out a SWEAP country would allow it to wipe off its sovereign debt from Eurozone banks over, say, three years, and to allocate the exposure to the original sovereign debt in a diversified way over various private-sector portfolios.

### **Eurozone membership cost–benefit analysis: a sovereign credit risk perspective**

Does a budget challenge in a Eurozone member country encourage the country to stay or withdraw from the Eurozone? To answer this question,

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one needs to know the advantage of exiting a currency (and creating a new – independent – currency) union when faced with budget deficit. Indeed, creating a new currency can help the country's exchange rate to depreciate and, thus, to

gain export competitiveness for a (not necessarily long) period of time. However, in the case of SWEAP countries, such policy cannot attain its aforementioned competitiveness goal as those countries are relatively small economies. Although they are open economies, they face real (not nominal) rigidities. According to Keynes, currency depreciation can have an impact on competitiveness, if nominal rigidities are in place. But, in the case of a relatively small SWEAP-type economy, further economic and political structural reforms would be key, first, if the goal is to gain sustained competitiveness using the currency valuation mechanism because, otherwise, the currency devaluation would lead to only limited short-term competitiveness gains before domestic prices adjust again and lead to competitive disequilibrium. Needless to say, there are key arguments for such countries to stay in a currency union, i.e. the Eurozone.

The benefits of keeping a Eurozone country subscription exceed their relevant costs, at least from a sovereign credit risk perspective.

First, according to Athanassiou (2009), although a country can exit EU membership given the Lisbon Treaty allows members to subscribe and, then, unsubscribe, a country cannot leave the Eurozone and remain as a European Union member. In plain English, if a Eurozone member country exits the Eurozone, then it will automatically be withdrawing from EU, losing the benefit of being able to count on EU countries' fiscal and financial support. Second, the cost of issuing sovereign euro-denominated debt would be cheaper than issuing sovereign debt denominated in the new currency. Third, the financial sector would be better off, from an accounting perspective, if the euro currency remains the domestic currency of reporting. Shifting to a new currency would cause inconvenience for financial institutions given that they will lose the benefit of having the ECB as a lender of last resort.

### **The long story short**

Fiscal pain and debt restructuring will be key tools to address effectively the ongoing Eurozone sovereign credit risk and fiscal crisis, especially in SWEAP countries. While the European Union already took a serious step to handle the financial system by the EFSF, the Eurozone can still push for liquidating or recapitalising European systematically risky financial institutions; strengthening disbursed loans conditions, along with attaching tough fiscal conditionality to them; and inventing a sovereign debt restructuring framework for consistency across Eurozone member countries. Indeed, the current financial endowment of the Eurozone allows default prevention in any of its member countries. While the Eurozone, overall, is currently in a better fiscal shape than the US or UK, a sovereign debt crisis (or even default) in any of its SWEAP countries could lead to serious damage to (i.e. breakdown of) the Eurozone itself. However, any rescue plan in the Eurozone should be accompanied by tough fiscal conditionality in order to discourage other Eurozone members from misbehaving fiscally.

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