

At Cross-Purposes: Commercial Versus Technocratic Governance of Sovereign Debt in the EU

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**ABSTRACT:** A perennial problem for fiscal governance in the euro area has been the lack of support from markets. Far from disciplining budgetary policies, capital flows financed deficits at historically low interest rates even when they broke EU fiscal rules. Theory would lead us to expect that the international-commercial and the supranational-technocratic assessments of sovereign debt are fairly aligned. But they were not. We show that credit rating agencies (CRAs) and Eurostat have rather different assessments of what certain policies mean for sovereign debt: the privatization of state-owned enterprises, pension reforms and more recently bank rescue programs. These assessments reveal divergent approaches. Private agencies are prone to conformism and herding behavior, allowing for little consistent discipline, while the public agency follows a bureaucratic imperative of accountability and transparency, which gets in the way of evolving policy priorities. Our findings thus shed light on the difficulties of fiscal governance by regulation only.

**KEYWORDS:** Euro area crisis, fiscal surveillance, sovereign credit rating

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### **EU Fiscal Governance and the Lack of Support by Market Discipline**

A perennial problem for fiscal governance in the euro area has been the lack of support from markets. Far from disciplining budgetary policies, capital flows financed deficits at historically low interest rates (Manganelli and Wolswijk 2007). They did so even when these deficits broke EU fiscal rules that were meant to signal to markets that budgetary developments were unsustainable. Some economists warned of the lack of market discipline (Fitoussi 2005, Faini 2006). It is safe to assume that the EU's fiscal rules could have been more easily enforced if financial market actors had supported the Commission's fiscal surveillance: for instance if rating agencies downgraded the bonds of offending member states reliably and investors imposed continually rising risk premia accordingly.

The lack of support for EU surveillance from rating agencies should come as a surprise even to those who do not believe that efficiency is an inherent feature of financial markets. After all, sovereign credit rating is a multi-billion dollar business, dominated by three agencies (Fitch, Moody's, and Standard & Poor's) that constantly provide information to markets about the credit risk of government bond issues. By mid-2010, Standard & Poor's (S&P) rated 125 governments, the other two over a 100 each (IMF 2010: 87). This makes reputation for accurate ratings extremely valuable. Moreover, there should also have been monitoring of these monitors. Credit ratings were built into the regulation of financial institutions, in that the risk-weights of the assets could be based on such credit ratings and thus determine the capital requirements under Basel II (IMF2010: 91-92). Since government bonds of OECD countries carried a zero risk weight and were therefore very attractive to meet capital requirements, it should at the same time have given independent financial regulators considerable incentive to make sure that the ratings of government bonds signaled problems of fiscal sustainability accurately. Last but not least, the European Central Bank (ECB), like other central banks, used these credit ratings in refinancing operations: in return for central bank credit, banks had to put up collateral that must meet a certain credit rating standard in order to be acceptable to the ECB. In sum, both financial and institutional incentives for reputation of commercial and technocratic monitors of public finances should have been aligned.

These considerations, and the puzzle they entail, can be supported by at least two conceptualizations of the European integration project. There is, first, the interpretation of the EU as a regulatory polity that suggests that it constitutes a 'fourth branch of government' for supranational economic regulation (Majone 1993, 1996). This theory seeks to explain why sovereign governments delegated considerable regulatory powers to independent bodies, such as the Commission or the ECB. In this view, delegation of policymaking powers guards against well-known failures of democracy to either represent the majority or to consider the legitimate interests of outsiders of national democratic processes, be it foreigners or future generations. In the medium to long run, these failures impoverish countries and the interdependence of economies makes national democratic failure a problem for other countries. Hence, governments agree on supranational institutions that mutually commit them to non-discrimination of foreign suppliers and migrant workers as well as restraint on destabilizing macroeconomic policies. Hence, the values that underpin a functioning market economy and efficiency-oriented supranational

regulation appear to be perfectly compatible and in the long-run interest of national democracies.<sup>1</sup>

At the opposite end of this functionalist view of EU policymaking is a constructivist interpretation that sees European economic integration as putting into practice neo- or ordoliberal ideas. This followed the perceived German success story at a time when Keynesian interventions seemed to fail (McNamara 1998). A singularly independent central bank and fiscal rules were introduced to tie governments' hands. The recent failure of financial markets on a colossal scale did not end the neoliberal reign, on the contrary, an 'austerity delusion' has taken hold of EU policymakers that is manifestly counterproductive for economic recovery (Blyth 2013: ch.3). In this view, the fiscal surveillance process can be seen as directly feeding financial investors with data, inviting them to sanction government behavior that would prioritize domestic redistribution and stimulus over the repayment of bonds. The role of credit ratings in the Basel II framework of financial regulation is further evidence for a close alignment of business interests and neoliberal ideas of government.

In order to solve the puzzle why EU fiscal governance is not more supported by bond market discipline, we exploit the empirical corollary of these theories: both imply that the international-commercial assessments of sovereign creditworthiness and the supranational-technocratic surveillance of budgets should be fairly aligned. Prospective bond buyers had in the Commission a potential ally and the regulatory/ neoliberal polity in fiscal policy should have directly fed into the assessment of sovereign creditworthiness by rating agencies. The commercial agencies' interest in the probability of sovereign default can be seen as a specification of the EU's interest in externalities of public debt accumulation, such as higher interest rates and inflationary pressures.

For our study of rating agency behavior, we concentrate on Standard and Poor's, which is the most active and influential agency in sovereign credit rating (de Haan and Amténbrink 2011: 5, 9). We analyze the content of Rating Methodologies and individual rating reports for individual countries issued by S&P.<sup>2</sup> For the study of technocratic fiscal surveillance, we analyze the ways in which Eurostat's statistical accounting translates data on pension savings, privatization and banking rescues into information about fiscal sustainability. So we turn the theoretical puzzle into the empirically researchable question: why do market actors and a supranational economic bureaucracy have different assessments of three government interventions?

We have chosen pension reforms, the privatization of state-owned enterprises, and bank rescue programs because they have strong fiscal consequences in contrast to, for instance, cuts in unemployment benefits. They also have sufficiently rich and complex budgetary effects so that their assessment is a non-trivial task. Their long-term effects can be different from the short-term, so they can reduce or increase the deficit. Finally, despite their similarities, these policy areas are of different interest to private and public bodies:

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<sup>1</sup> Majone envisaged a narrow mandate for the EU, such as free trade in the Single market and stability-oriented monetary policy by an independent ECB. Not surprisingly, the regulatory polity has proven to be politically more conflictual than Majone's functional assignment suggests and by resolving these conflicts, it encroaches on core state powers (Mabbett and Schelkle 2009, Genschel and Jachtenfuchs 2013).

<sup>2</sup> The evidence is based on 267 country reports between 1999 and 2012. Reports specifically referenced in this text are specified by country acronym and publication date.

privatization is a policy of intense interest to private investors while pensions are of more remote relevance; both are equally important policy issues for public agencies. Bank rescues are a casualty, not on anybody's policy agenda. This allows us to see how commercial and technocratic monitoring of sovereign debt interpret complex data and turn it into information about fiscal sustainability or sovereign creditworthiness, respectively.

The next four sections analyze the rating and statistical accounting of the three policy measures as well as recent changes to the approach of CRAs and to fiscal surveillance in the wake of the economic and financial crisis. In the last section, we discuss our findings and we try to answer the overall question of why EU fiscal governance by regulation only is so unsatisfactory, both from the point of view of those who are concerned about high debt and those who are concerned about constraints on fiscal stimulus.

### **Privatization of public assets**

The privatization of public enterprises was arguably part of the EU agenda in creating the Single Market, for instance in public utilities. Privatization was seen as supporting integration by removing market segmentation and protective barriers (Sauter and Schepel 2009: 4-5). Fiscal surveillance may not be entirely supportive of this thrust because privatization can entail a loss of assets and revenue-generating capacity of public finances. The international accounting rules, which Eurostat has helped to design, are of special importance as they may encourage or discourage privatization of public enterprises depending on what selling public assets means for headline fiscal figures.

These rules had special significance in the run-up to the launch of the euro. In the Maastricht process, member states tried to meet the fiscal criteria for entry, the notorious 3 per cent deficit-to-GDP and the 60 per cent debt-to-GDP ratio, by selling public enterprises (Savage 2005: 25). The idea was to generate deficit-reducing revenue and, in the case of indebted state-owned enterprises, to reduce debt. The latter is possible insofar the Maastricht criterion on debt is a gross concept, i.e. it is not netted against assets. On the other hand, the fiscal criteria measure only the deficit and debt of general government, which excludes state-owned enterprises in the public sector if they are in principle commercial undertakings, producing for markets and selling in markets.

Eurostat developed the following principle regarding the question whether a country can use privatizations to meet the fiscal Maastricht criteria or not (Savage 2005: 81-89): only the direct sale of non-financial assets like building, land and inventories reduces the deficit. This transaction does not affect the asset side, as it is normally just seen as a change in the structure of asset holdings, say from equity to cash. By contrast, selling financial assets, such as a financial stake in a state-owned enterprise, will not affect the budget balance of the government as the revenues from the sale are matched by the loss of revenues from holding these financial assets (e.g. dividends). Savage (2005: 88) notes that the European System of Accounts 'produces an interesting disincentive for privatizing public enterprises for purposes of deficit reduction, but a counterpart incentive for purposes of debt reduction'. The latter is the case because selling non-financial assets is not counted as a loss of revenue-generating assets and the proceeds can be used to reduce debt.

A live issue then and now is the 'cleaning out' of state-owned enterprises before privatization (Eurostat 2013: 142), namely to assume debt or obligations that could scare off prospective investors. The clean-out typically requires a one-off payment from the company

as compensation for the government taking over all or part of the liabilities, notably pensions for the employees. This could be timed such that it helps the government to enhance its budget balance at a convenient moment. Eurostat (2013: 142-143) accepts the lump sum payment to the government as deficit-decreasing revenue. This revenue will be offset by future payments of pensions that increase the deficit. However, if the lump-sum or one-off payment does not match the actuarial value of the obligations, the difference must be recorded as a deficit-increasing capital transfer if the lump sum is too low while it must be recorded as a deficit-neutral 'withdrawal of equity' (switch of public asset composition) if it is too high (Eurostat 2013: 143). This asymmetry means that the accounting rule penalizes debt assumption by government but does not reward implicit taxation of investors in privatization.

Perhaps the most (in-)famous instance of statistical case law, namely *France Telecom* (1996), concerned exactly such an exercise of assuming unfunded pension obligations in return for a payment by the corporation, to the tune of 0.5% of GDP that the French Treasury was to receive.<sup>3</sup> A very public battle between the European statisticians and the French Treasury ensued. The former argued that the payment did not come with contributions from the employees, hence must be counted as a deficit-increasing capital transfer, while the French authorities claimed that it must be counted as revenue. The revenue would get the country some way towards meeting the Maastricht deficit threshold, given a deficit of 4.1% at the time. The aggressive handling of the case by Eurostat, interestingly under its then French chairman, made it ultimately lose this battle against the French Treasury.

Unsurprisingly, S&P ratings view privatization very positively. Commercial investors are profoundly interested in the investment opportunities that privatizations create and they are major clients of CRAs. Even in specific cases, S&P did not take into account that governments may lose revenue by disposing of public assets and thus impair their future creditworthiness. In successive methodologies, S&P expresses its reservations against large public sectors. First, a large public sector decreases a country's policy flexibility, because sizeable public employment generates a fixed commitment of a substantial amount of government resources. Second, a large public sector is deemed to limit a country's growth potential; the epithet 'inefficient' invariably accompanies any mention of a 'large public sector'. Third, the presence of a significant number of state-owned enterprises raises suspicion about the off-balance sheet liabilities that a government might need to deal with in the future and thus creates uncertainty about the country's true fiscal position. Therefore, privatization can be unambiguously expected to give a boost to ratings through both the fiscal score – in terms of increasing policy flexibility and improving transparency of the real fiscal situation – and on the economic score by improving growth prospects. None of the methodologies mention how the loss of assets or the loss of future revenue producing capacities could affect the fiscal position of the country or, indeed, take into consideration the intricacies of needing to 'clean-out' public enterprises of liabilities before their sale. It is especially noteworthy that S&P does not mention new liabilities taken on by the state in the

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<sup>3</sup> The France Telecom case can be revisited in the surprisingly gripping account of Savage (2005: 110-121).

course of privatization given that methodologies explicitly warn of liabilities *hidden* in publicly owned enterprises (S&P 2006: 11).

The picture emerging from the country rating reports is less straightforward, however. It is not clear to what extent privatizations influence the actual rating score. Rating reports often criticize countries whose public sector is deemed to be too large. They also recommend privatization and praise the countries that undertake it, with the caveat that one-off improvement in deficit figures due to privatization should be treated with caution. But none of this translates directly into actual ratings scores. Rating reports have repeatedly warned Austria, Denmark and France that their governments are too large, yet all three countries remained AAA-rated before the crisis<sup>4</sup>. When Austria and France were downgraded in January 2012, the size of their public sectors was not mentioned as a reason (S&P Au2012Jan13 and Fr2012Jan13). France was subsequently downgraded again in November 2013 for lack of structural reforms of labor markets, rather than too little privatization (FT 2013 Nov). For lower-rated governments, however, efforts to slim their public sectors via privatization seem to matter. When they were upgraded in the 1990s, Greece, Italy and Portugal were commended for their structural reforms, including privatizations, and when they were downgraded on several different occasions during the 2000s, lack of further structural reforms was quoted as one of the reasons<sup>5</sup>. It is difficult, however, to separate out the independent effect of privatizations on the rating scores, because these successive upgrades and downgrades coincided with improving and then deteriorating trends in public finance. While S&P provides unambiguous support for privatization in the qualitative analysis provided by its rating reports, it is unclear to what extent it is willing to 'enforce' such recommendations through the rating score it awards.

In sum, despite the general agreement between EU authorities and S&P about the desirability of privatization at the level of principles, the tangible incentives that the supranational and commercial channels of surveillance provide are quite different. European statistical rules encourage privatization to reduce current debt but not deficit figures that would allow governments to prettify their fiscal performance. They even allow the exchange of current deficits for future deficits, in that present deficits can be reduced by payments received from companies in return for liabilities being transferred to the state. But Eurostat has also been at pains to ensure that some of the hidden losses entailed in the sale of government assets are recorded transparently, albeit their efforts have not always been successful as we saw in the France Telecom case. S&P on the other hand, did not acknowledge costs of privatization. Issues like the assumption of implicit liabilities have never been mentioned in either methodologies or in rating reports. Apart from the occasional warning that one-off measures to decrease the deficit should be greeted with caution, the reports do not take into consideration that privatization deals may be myopic and reduce a country's long-term creditworthiness. That said, given the multitude of factors

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<sup>4</sup> S&P Au2000June13, Au2003May21, Au2004Apr15, Dk1999Apr28, Dk2001Feb27, Dk2007Sep26, Fr2001Jan24, Fr2002Jan28, Fr2003Mar9, Fr2004Jan20, Fr2006Feb28,

<sup>5</sup> S&P Gr1999Nov24, Gr2001Mar13, Gr2002July3, Gr2003June10, Gr2004Sep13, Gr2005Nov8, Gr2007Mar6, It1999May27, It2000Apr19, It2001Oct26, It2003Jan15, It2003Nov25, It2004July7, It2005Aug8, It2006Oct19, It2007Oct23, Pt2000Apr5, Pt2001June21, Pt2002Oct31, Pt2004Oct29, Pt2005June27, Pt2006Mar29, Pt2006Oct30, Pt2007Oct25

that are taken into consideration in the rating process, it is impossible to identify the tangible incentives that S&P provides for selling public enterprises. We conclude that commercial and technocratic assessments are not aligned, despite overall support for privatizations by both institutions. Fiscal surveillance effectively constrains privatization if it suspects short-termist deficit reduction.

### **Pension Reforms**

The increasing pension liabilities of governments have bothered EU fiscal surveillance for some time. Member states must provide estimates of the evolution of age-related contingent liabilities over a rolling 50-year horizon in their annual stability programs. There are dedicated publications, such as the tri-annual Ageing Reports and the Fiscal Sustainability Reports, in which the European Commission regularly quantifies the effects of ageing on the ratios of workers to pensioners, on government expenditure and on debt.<sup>6</sup> In the country-specific recommendations issued under the European Semester, the Commission urges pension reform, notably increasing the retirement age, reducing public pension entitlements and introducing mandatory personal pensions, in more than half of the member states (SPC 2008).

However, despite these revealed concerns about the demographic drivers of sovereign debt, the statistical accounting for pensions has not managed to incorporate the issue in a way that provides incentives for the recommended pension reforms. Eurostat is quite explicit about the difficulties to account consistently for the various tiers or pillars of old age security. The 'Manual on Government Deficit and Debt' notes, with an undertone of regret, that there is an inconsistency in the accounting between pension obligations from funded and from unfunded schemes (Eurostat 2013: 144): while the obligations under the former are counted as gross debt which is not offset by the assets, under the latter obligations are not counted as debt and become visible only as they arise in future expenditure. In this European accounting sense, the move to a funded public pension pillar is therefore not made attractive for any administration currently in power. Another consequence of these accounting rules is that pension liabilities can be made to disappear in the context of privatizations of state-owned enterprises, namely by transferring them from a funded occupational scheme to a public pay-as-you-go scheme. Thus, rather than shifting from public unfunded to private or collective funded schemes, there are incentives to move in the opposite direction.

Another issue concerns defined-benefit schemes: public pensions typically promise a certain level of benefits irrespective of the individual contributions. But given the uncertainty of life expectancy, public pension schemes tend to be underfunded and so the question arises how one can account for the fact that the present value of promised benefits exceeds the present value of actual contributions. The European statisticians rule that government payments to restore the balance of a defined-benefit scheme must be counted as a deficit-increasing transfer (Eurostat 2013: 20). Defined contribution schemes, by

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<sup>6</sup> For fiscal surveillance, see the dedicated website of DG Ecfm at URL: [http://ec.europa.eu/economy\\_finance/structural\\_reforms/ageing/pensions/index\\_en.htm](http://ec.europa.eu/economy_finance/structural_reforms/ageing/pensions/index_en.htm) (accessed 21 December 2014).

contrast, are never part of social security and thus general government in accounting terms because individuals get only the benefits that match the value of their contributions. Eurostat (2013: 20) mentions, however, these schemes are sometimes also constructed with redistributive elements (i.e. individual contributions do not match benefits ex ante) and thus can lead to payments that should be relevant for the balance recorded under fiscal surveillance, yet they are not.

The commercial rating of pension liabilities shows other signs of inconsistency. The stance of S&P on pension reforms evolved in a curious fashion over time. In its rating methodologies issued in 2006 and 2008, S&P emphatically warned of the risks to fiscal sustainability that ageing would bring and warned that sovereigns that fail to address age-related spending pressures might be downgraded in the medium term (S&P 2006: 10; S&P 2008). Country-specific rating reports also repeatedly brought up the issue of the risk of age-related spending increases. Austria, Belgium, France, Germany and Italy were frequently urged to address their vulnerabilities in this regard<sup>7</sup>. In other countries, the absence of rising pension liabilities was stressed as a factor that led to stronger ratings. Favorable demographics and prefunding were mentioned as important strengths in Ireland, a fully funded and sizeable second tier propped up ratings for Denmark, whereas the UK was commended for its largely private pension provision<sup>8</sup>. Since the start of the crisis, however, S&P has put much less emphasis on pension reforms. Compared to the alarmist tone in earlier methodologies, the revised methodologies issued in 2011 and 2013 explicitly downplay the aging-related risks to sovereign creditworthiness and emphasize that in many cases there is still sufficient time to address these issues (S&P 2011: 26 and S&P 2013: 26). In line with this change of methodologies, the individual country reports have become mostly oblivious of the issue of ageing and of pension reforms.

In sum, commercial rating and supranational surveillance go into opposite directions as regards their assessment of reducing public pensions. Eurostat flags up the issue but consistency of statistical rules prevents it from accounting for the contingent pension liabilities in public budgets in the headline fiscal indicators, the debt- and deficit-to-GDP ratios. At the same time, fiscal surveillance has found other venues, such as the European Semester and the regular stability programs, to drive home the message. S&P issued warnings that it would initiate downgrades if a government failed to deal with age-related expenditures but hardly ever acted on it. More recently, this CRA has backtracked on pension reforms considerably. There is certainly no alignment in this policy area.

### **Crisis Management: Economic Stabilization and Bank Rescues**

The financial and economic crisis since 2007-08 forced governments to temporarily set aside fiscal rigor in an effort to prop up their ailing economies with stimulus measures. It also pushed governments into bank rescues on a truly astounding scale, for fear that otherwise

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<sup>7</sup> S&P Au2000June13, Au2003May21, Be1999Feb1, Be2002Feb18, Be2003Mar18, Be2004Jan23, Fr2001Jan24, Fr2002Jan28, Fr2003Mar19, Fr2004Jan20, Fr2006Feb28, Ge2002Dec10, Ge2003May6, Ge2005Mar1, Ge2005Nov16, Ge2006Dec19, It1999May27, It2000Apr19, It2001Oct26, It2003Jan15, It2006Oct19

<sup>8</sup> S&P Dk2001Feb27, Dk2002Mar26, Dk2003Apr9, Dk2004Aug26, Dk2005Sep30, Dk2006Sep25, Dk2007Sep26, Ir1999Aug13, Ir2000Oct3, Ir2001Oct3, Ir2002Sep5, Ir2003Oct30, Ir2004Dec23, Ir2005Dec20, Ir2006Dec21, Ir2007Nov23, UK2003June24



the banks' struggle for survival, for instance by going aggressively after households with difficulties to service their mortgages, would bring down the economy and inflict unacceptable social disruption on core constituencies. Governments guaranteed banks' liabilities, took over their bad assets or temporarily nationalized insolvent financial institutions. How much leeway do the two forms of fiscal monitoring provide to governments in these testing times?

EU fiscal rules that guide surveillance arguably prioritize prudent public finances over the stabilization of the economy; the accounting principles to generate the underlying information are designed accordingly. At the same time, the SGP allows, in principle, to exempt a country from an excessive deficit procedure if the imbalance is caused by a deep recession. Although the Council opened an excessive deficit procedure against every country that missed the three per cent deficit ratio during the crisis, no member state was fined. Only one country, non-euro member Hungary, came close to being fined when the Council and the Commission threatened to block regional funding if the government would not make more efforts to rein in its deficit<sup>9</sup>. In the end, Hungary did correct its deficit and the threat was dropped (European Commission 2012).

As far as bank rescues are concerned, Eurostat put out extensive communications since the start of the financial crisis to clarify the rules and made decisions on the treatment of 'financial defeasance structures', as bad banks are called in official language. These ensure that costs incurred and liabilities assumed by governments cannot be kept off the books unless there is a very strong chance that they either will not materialize or that they can be turned into profitable investment in the future. The most important principles distinguish the various rescue measures. Capital injections in 'too big to fail' entities are grants that are deficit-increasing (Eurostat 2013: 112, 120). By contrast, government guarantees of a bank's liabilities, notably savings deposits, affect neither debt nor deficit and only once the guarantee is called, does it increase the deficit (Eurostat 2013: 188, para 33). If the guarantee keeps a unit alive that is not really active in markets any more, Eurostat (2013: 188) puts down criteria for financial defeasance that national accountants can use to establish whether it has actually turned into a vehicle to wind down some of the former business. This is the case for instance, if the guaranteed bank is closed to new deposit taking or lending. In other words, only guarantees that do not meet the criteria for financial defeasance are below the line of relevant fiscal items in the Commission's surveillance.

Furthermore, the transfer of bank assets and liabilities is subject to asymmetric valuation principles. If a bank or some of its assets and liabilities become part of a defeasance structure, the difference between the transfer value of the assets and the market or fair value is a capital transfer to the debtors (banks) of the defeasance structure that increases the deficit (Eurostat 2013: 183-186). In a crisis, this difference and hence the effect on government deficits are likely to be overstated because market or fair values tend to be unduly low in distressed markets. Revaluation of the assets later, for instance due to rising prices for real estate, are not taken into account for the net lending or borrowing of the government (Eurostat 2013: 184, para 19; 185, para 21; 187, para 30). The assets and liabilities of a bad bank also come on the government books, hence (gross) debt of general

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<sup>9</sup> Arguably, this might have been a sanction for other violations of the *acquis communautaire*.

government increases. These accounting rules generate considerable penalty for bank rescue measures in the European system of fiscal surveillance.

S&P's approach creates even greater difficulties for governments in trying to deal with economic and financial crises. Since the start of the crisis S&P has aggressively downgraded previously high-rated countries – like Ireland and Spain – for disappointing growth prospects and for assuming large liabilities in bailing out troubled banks. The current heavy-handed response stands in marked contrast with the leniency exercised before the crisis. From the mid-2000s, S&P had voiced concerns about an overheating economy (Ireland), excessive private sector indebtedness (Ireland and the UK), bubbles on the real estate markets and the possibility of sharp corrections (Ireland, Spain and the UK)<sup>10</sup>. Although all of these factors foreshadowed problems with growth and the banking sector, the agency did not consider a downgrade or even a negative creditwatch<sup>11</sup> back then. Since the start of the crisis, however, rating methodologies have been updated to put more emphasis on growth prospects and the stability of the banking sector and the new prescriptions are enforced with unflagging rigor, without any allowance for the exceptional circumstances.

S&P downgraded governments for bank rescues irrespective of whether they took the form of guarantees, capital injections or nationalizations. For example, Ireland – which still received a clean bill of health as late as November 2007<sup>12</sup> – was issued a negative outlook in January 2009 after its government issued guarantees to seven national banks. It was then downgraded six times in the following three years as the massive costs of those guarantees materialized<sup>13</sup>. Importantly, once the scope of the banking crisis became clear, S&P did not restrict itself to rate explicit government measures but sought to provide forward-looking evaluations by carrying out in-house modeling of the further costs of saving banks<sup>14</sup>. In none of the successive rating reports was there allowance for the beneficial effect bank rescues might have for the health of the banking sector and the economy in the longer term. Spain's experience was similar. On three occasions, downgrades were prompted by S&P's progressively worsening forecasts of the likely costs of government involvement in saving the banking sector (S&P Sp2010Apr28, Sp2011Dec5, Sp2012Apr26). Efforts to restore a viable banking industry came into consideration only as a downside risk for public finances.

In sum, the two systems of surveillance also display considerable differences. The SGP has an escape clause to allow for suspending fiscal rules in times of recession, although the Commission opted not to use it. In the handling of bank rescues, Eurostat aims at maximum accounting accuracy and transparency by differentiating between the different

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<sup>10</sup> S&P Ir2004Dec23, Ir2005Dec29, Ir2006Dec21, Ir2007Nov23, Sp2004Dec13, Sp2005Nov28, Sp2006Nov28, Sp2007Nov26, UK2005Mar31, UK2006Nov10

<sup>11</sup> A negative creditwatch is typically the instrument CRAs used to warn the bond issuer that a downgrade is imminent if no measures are taken (de Haan and Amtenbrink 2011: 4-5).

<sup>12</sup> The 2007 November credit report contended that 'Ireland's extremely strong [AAA] credit standing should remain secure against most foreseeable downside economic, political, and financial risks' (S&P Ir2007Nov13: 3).

<sup>13</sup> S&P Ir2009Mar30, Ir2009June8, Ir2010Aug24, 2010Nov23, Ir2011Feb2, Ir2011Apr1

<sup>14</sup> Examples of the type of independent assessment of the costs of banking crisis can be found in the March 2009 and the April 2010 rating reports on Ireland (S&P Ir2009Mar30:2-3 and Ir2010Apr8: 2-3).

instruments governments use for bank rescues and by only recording the actual costs of a transaction once financial defeasance materializes. By contrast, S&P assesses bank rescues indiscriminately (negatively), and it has sought to adopt a proactive approach by penalizing government involvement in the troubles of the banking sector even before the costs of government intervention can be known with a reasonable degree of certainty. For S&P, weak growth is a main reason for downgrading countries.

### **Changes in Fiscal Monitoring in the Wake of the Crisis**

Our comparison between fiscal surveillance by a deliberately technocratic body and credit rating by a commercial agency shows noticeable differences between the two ways of fiscal monitoring. The recent responses to the crisis by Eurostat, on the one hand, and by S&P, on the other, confirm and reinforce this finding. While Eurostat has sought to emphasize the continuity of the principles of the European System of Statistics, S&P has gone out of its way to demonstrate that it has incorporated into its methodologies and assessments the most important lessons of the crisis.

Although Eurostat naturally had to respond to new issues as a result of the crisis, it sought to address these issues emphatically through the continuation, or 'clarification', of existing principles. For example, when it upgraded its Manual on Government Deficit and Debt in 2013, only one of the three new chapters related to the crisis. This chapter dealt with new 'European entities related to the Euro Area sovereign debt crisis', i.e. the emergency fund, the European Stability Mechanism with its predecessor EFSF, which provide credit to governments under attack in bond markets. All other issues raised by the crisis, like financial defeasance or the capital injections on an unprecedented scale in the case of Ireland, did not make Eurostat invent new accounting devices but issue 'clarifications'. There are no significant changes to the recording of the other two policy areas analyzed above, pensions and privatizations.

Eurostat also stresses the consensual character of its decisions concerning issues emerging from the crisis. The new Manual refers to wide-ranging consultations on the clarifications and refinements of existing principles: 'It is the result of a collective work, coordinated and animated by Eurostat, by experts in Government Financial Statistics and national accounts representing EU Member States, the Commission (the Directorate General for Economic and Financial Affairs) and the European Central Bank.' (Eurostat 2013: 1) The attempt to uphold continuity and transparency in the European System of Statistics is based on a conspicuous consensus among national and international experts, thus fending off criticism and interventions by some treasuries.

By contrast, S&P has emphasized change, adaptation to shifting conditions and the incorporation of new lessons into assessments of creditworthiness. Since the start of the crisis, S&P issued three new methodologies, in 2008, 2011 and 2013. These successive iterations of methodologies integrate new issues and discuss old ones in more detail than before. All three policy areas discussed above have been subject to considerable revisions. The urgency of pension reform is now explicitly downplayed, as already indicated (S&P 2011: 26 and 2013:26). Privatization and structural reform also receive much less emphasis. Accordingly, these issues literally disappear from individual country reports. Contingent liabilities generated by an unstable banking sector are discussed in much greater detail than before (S&P 2011: 28-30 and 2013: 28-30). Growth prospects also become a central issue

and a long section is dedicated to explaining how they are assessed (S&P 2011: 17-18 and 2013:17-18)<sup>15</sup>. These new issues affected the ratings of a host of countries besides Ireland and Spain. Growth concerns led to falling ratings in Greece, Italy and Portugal, whereas problems with the banking sector contributed to downgrades of Belgium and potential banking problems cost Austria its AAA rating<sup>16</sup>. An important new issue in focus is crisis management or, more specifically, the ability of governments to respond to economic and financial shocks (S&P 2011: 13 and 2013:13). Finally, the constraints on policy adjustment in countries that are members of monetary unions are mentioned for the first time in the two newest methodologies (S&P 2011: 34-35 and 2013: 34-35). The new focus on the latter two issues motivated an unprecedented collective rating report issued in January 2012, which simultaneously reviewed existing ratings for all euro-members in response to what was seen as weak crisis management at the European level, by the Commission and the ECB<sup>17</sup>.

The reforms in rating methodologies and profound changes in the rating approach indicate that credit ratings do not have a consistent methodological basis to make them usable for regulatory purposes. Instead, ratings focus on current issues that are of most interest to market investors at any given moment. This explains both why S&P placed such emphasis on privatizations and pension reforms before the crisis, even though these issues have only a tenuous relationship to the probability of sovereign debt default, and why it was so willing to disregard these issues once the crisis threw up others. This approach stands in marked contrast with Eurostat's insistence on maintaining continuity and consistency despite the extraordinary times.

### **Discussion and Conclusion**

Our take on these findings is that they support neither the regulatory polity interpretation, which sees the EU as a fourth branch of government for supranational economic regulation, nor the neoliberal project view, which construes EU fiscal governance as an institutionalized practice of neoliberal ideology. The differences in the approaches Eurostat and S&P charted in the previous sections reveal that the two types of monitoring do not complement each other well enough to allow either for effective fiscal discipline or to generate consistent neoliberal pressure on policy making.

To start with the latter: since S&P cannot be unambiguously classified as truly neoliberal, its interaction with Eurostat does not lead to a persistent advancement of a neoliberal policy agenda. The thrust of S&P's rating is not consistent enough to achieve the coherence of an ideology. Rather than dependably pushing for neoliberal policy choices, it is transparently opportunistic in that it tries to speak to market concerns about the risk-return

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<sup>15</sup> Interestingly, the new methodologies explicitly promise to avoid the mistake that S&P committed when not acting upon asset-bubbles and credit fuelled growth in Spain and Ireland before the crisis: "A sovereign's economic score would be one category worse than the initial score, when GDP growth seems to be fueled mostly by a rapid increase in banking sector domestic claims on the private sector, combined with a sustained growth in inflation-adjusted asset prices, indicating vulnerability to a potential credit-fueled asset bubble." (S&P 2011:17, a similar paragraph can be found in S&P 2013:16)

<sup>16</sup> S&P Au2012Jan13, Be2011Nov25, Gr2010Apr27, Gr2012May2, It2011Sep19, Pt2010Apr27

<sup>17</sup> In this collective rating action, nine sovereigns were downgraded, whereas the ratings of seven others were affirmed (S&P 2012).

prospects in sovereign credit. The concern post-crisis is low growth that can lead to adverse income flow and debt stock dynamics even when the fiscal headline figures are improving. Privatization of pensions and of public assets were put on the backburner at a time when households are financially overstretched and financial institutions reluctant to invest in illiquid assets. The fact that a CRA partly anticipates and partly follows investor interests as they perceive them does not make it neoliberal. Furthermore, Eurostat's independent effect on policy is not unambiguously neoliberal either. For example, accounting rules do not give a straightforward incentive to retrench public provisions or to privatize pensions. On the contrary, Eurostat's rules make public finances look better if the government takes over pension liabilities from state-owned enterprises into a pay-as-you-go system in return for a lump-sum payment.

The regulatory polity theory would require that European fiscal surveillance provide fiscal discipline that reconciles dependable rigor with the collective interests of member states. A supranational regulator is required to solve this collective action problem, namely not to overuse the common resource of a stable currency. If one considers this to be the prime problem of a monetary union, as the architects of the euro area certainly did, then the regulatory polity theory has some evidence on its side. S&P's manifest failure to exert consistent pressure for fiscal restraint on countries supports the view that enforcing discipline cannot be left to the markets and a supranational public agency is required instead.

It is debatable, however, whether European fiscal surveillance manages to further collectively desirable policies while regulating budgets in this way as the theory requests. Eurostat's striving for stability of rules and its ostentatious reliance on international expert consensus is consistent with the role of a supranational regulator. Yet, being bound so tightly by its own statistical rules can also come into conflict with policy priorities evolving during a crisis for which these rules were not written. Bank rescues are a case in point (Mabbett and Schelkle 2014: 15-22). Under Eurostat rules all measures aimed at consolidating banks affect public finances negatively, except for guarantees. This fiscal accounting gave European governments no incentives to pursue bank recapitalizations and restructuring. The revealed, if contingent liabilities urge governments to prioritize budget consolidation, not for fear of an EDP but for fear of market panic. Ireland, Italy, and Spain were in this situation. National banking systems then survive mainly because the ECB throws them a lifeline, by offering them very low refinancing in the hope that they earn higher returns and recapitalize themselves out of the margin<sup>18</sup>. However, this means that Eurostat's rules contribute to perpetuating a regime that is in the short-term interest of national democracies but not conducive to what is officially considered good governance of the union.

The observed divergence between monitoring and responses to the crisis shows the difficulty of a purely regulatory approach to fiscal governance. Without a budget that could

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<sup>18</sup> The number of banks that are thus kept alive is much higher than the indicator of defeasance structures all over Europe shows. The ECB is forced to keep many banks on its list of monetary and financial institutions with access to the discount window. If they were declared part of defeasance structures, the ECB could not support them with its liquidity measures as this would fall under the prohibition of monetary financing of governments (Mabbett and Schelkle 2014: 19-20).

provide incentives for compliance or fill the gaps left by member states, regulation by supranational bureaucracies will be imperfect even if they seek to enlist the help of market actors. The Commission, in the disguise of Eurostat, follows a bureaucratic imperative of continuity, accountability and transparency, whereas monitoring by CRAs is driven by market opportunism and herding behavior. Neither is fully justifiable on economic grounds, especially not under the circumstances of a crisis. They are driven by institutional logics, an administration, on the one hand, and of commercial firms, on the other. This is not by mistake but an inherent trait of each.

Rating agencies insist on their assessments being fundamentally different from regulatory purposes and now object to the regulatory role ascribed to them. This view is clearly expressed by the Chief Risk Officer and Chief Credit Officer at Moody's: 'The growing use of ratings in regulation had given rise to three potentially adverse industry dynamics: (i) the substitution of regulatory demand for investor-driven demand for ratings, (ii) the growing perception that ratings were something more than an opinion as a result of their official recognition by regulators, and (iii) a vicious circle of intrusive regulation to induce ratings and rating agencies to behave in line with regulatory needs, potentially changing the nature of ratings.' (Cantor 2013: 27) In interviews, senior decision makers at S&P expressed similar reservations against their regulatory role. CRAs define their role as service providers to the financial industry, not as actors outside or beyond that industry. They stress that what they offer is an opinion on creditworthiness meant to help investors in their own decision-making process rather than authoritative assessments of credit quality to be used for regulatory purposes. Key in this distinction is the room for qualitative, subjective assessment that is recognized as such.

This emphasis on 'opinions about creditworthiness' might be self-serving, namely to limit legal liability and defending their autonomy, but it is still an insight that needs to be heeded by those who hope that a tightened fiscal surveillance regime and new rules for sovereign credit rating can do the trick for EU fiscal governance. New regulation on the rating business came into force on June 20, 2013, seeking to make it more transparent, more predictable and more accountable<sup>19</sup>. However, such rules have little chance of transforming CRA activities as desired by the regulator if CRAs and the regulator disagree about what rating agencies do.

Market discipline, even if it reliably existed, is not a natural ally of prudent regulation. When markets become a binding constraint on government finances, they usually trigger a crisis that, for better or worse, nobody is prepared to simply let run its course. The EU approach of regulating governments into ever more transparency and accountability is prone to distort the lessons to be drawn from any of these financial crises.

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<sup>19</sup> The new rules mandate CRAs to set up a calendar indicating when they will rate Member States and to rate sovereigns at least every six months, but not more often than three times a year. They also stipulate that rating changes may only be announced on Fridays after close of business to allow governments to react to the news before markets can move. They require CRAs to make their methodologies public and invite comments from stakeholders. They also demand that CRAs disclose the assumptions that their assessment is based on. They seek to create greater accountability by making CRAs liable for errors caused by 'gross negligence'. (see: [http://europa.eu/rapid/press-release\\_IP-13-555\\_en.htm?xrs=RebelMouse\\_tw](http://europa.eu/rapid/press-release_IP-13-555_en.htm?xrs=RebelMouse_tw) accessed on December 29, 2014).

It always starts and ends with holding governments accountable, regardless of whether sovereign debt is the cause in the first place.

This is risky and potentially self-defeating. If private debt and credit, accumulated through current account imbalances and household finances, leads into a balance sheet recession, then sequencing of private and public deleveraging is required (Bornhorst and Ruiz-Arranz 2013). Yet, Eurostat's understandable attempt to be consistent is maximally unfavorable to sovereigns. These biases contribute to the fragility of the euro area (De Grauwe 2011). Other institutions of the EU, notably the emergency fund ESM and the ECB, then have to compensate for these biases, created by an unholy alliance of commercial and technocratic monitoring of sovereign debt.

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