advanced economy solutions for what are, in reality, emerging market style sovereign debt crises. Just as in other debt crises-resolution episodes, their responses will include debt buybacks (as in Greece) and debt-equity swaps.

Another option, which seemingly holds out the attraction of avoiding some of the aforementioned costs or at least spreading them over time, will be to attempt to limit the effective cost of debt by requiring domestic financial institutions to hold it. While advanced economies are unlikely to call their policies financial repression when more politically correct characterizations, such as prudential regulation, are available, they could move to a system more akin to what the global economy had prior to the 1980s market-based reforms. That system of domestic and external financial regulation was instrumental in keeping real interest rates low (and often negative) and reducing advanced economies' government debt levels from their record highs at the end of World War II.

Some recent moves suggest governments might attempt similar measures today. Basel III provides for the preferential treatment of government debt in bank balance sheets via substantial differentiation (in favor of government debt) in capital requirements. Other approaches may be even more direct. For example, at the height of the financial crisis, UK banks were required to hold a larger share of gilts in their portfolios. The IMF's April 2011 *Global Financial Stability Report* documents how Greek, Irish, and Portuguese banks have already liquidated a substantial fraction of their foreign assets and swapped those into domestic public debt.[23] Evidently, the process whereby debts are being "placed" at below market interest rates in pension funds and other more captive domestic financial institutions is already under way. Spain has recently reintroduced a *de facto* form of interest rate ceilings on bank deposits.[24,25] At the same time, however, it remains to be seen whether governments have the ability to go much further in today's financially-sophisticated, high-capital-mobility world.

If governments do embark on this path, central banks are likely to come under pressure to be part of this process, as they were in the period after World War II. In many countries, central banks are financial regulators, so the impetus for, or at least acquiescence to, measures compelling other financial institutions to hold government bonds will have to come from the central bank, and the central bank will come under political pressure to provide it. The central bank may also come under pressure to support bond prices—or equivalently, to cap interest rates on treasury bonds—as was the case in the United States prior to the Treasury-Federal Reserve Accord of 1951 that restored the Fed's operational independence. The European Central Bank has already engaged in limited purchases of the government bonds of heavily indebted euro-area countries and is under pressure (as we write) to undertake more, with the effect of transferring sovereign obligations onto its own balance sheet.

The normative question (which we address in the concluding section to this chapter) is whether, under what circumstances, and how far the central bank should go down this road. As discussed earlier, the conceit behind central bank independence and inflation targeting is that monetary policy

[23] See Figure 1.17 in that report. The question of course being the extent to which this reflects regulation, public pressure, or private incentives.

[24] See http://www.lavanguardia.mobi/mobi/noticia/54140090670/El-Gobierno-limita-las-superofertas-de-depositos-bancarios-con-mas-exigencias.html

[25] Our discussion has focused primarily on Western Europe, but similar trends are emerging in Eastern Europe. Pension reform adopted by the Polish parliament in March of this year has met with criticism from employers' federations and business circles**.** According to the Polish Confederation of Private Employers Lewiatansay, the proposal seeks to hide part of the state's debt by grabbing the money of the insured and passing the buck to future governments. The confederation also points out that moving money from pension funds to ZUS will protect the government from having to change the definition of public debt and exceed financial safety thresholds, but will expose future retirees to losses. Struggling with budgetary pressure at home, Hungary has nationalized its pre-funded pension schemes and excluded the cost of the reforms from their public debt figures. Bulgaria has taken measures in the same direction.