National Debt Policies in Europe after the Crisis

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Introduction

The European fiscal crisis that started in Greece in 2010 has made the governance problems of the Eurozone staggeringly evident. One of the fundamental roots of these problems is an unusual asymmetry built into the institutional design of the European Monetary Union (EMU): while monetary policy is centralised and conducted by a common European Central Bank (ECB), budgetary policies are left to the individual nation states. The origin of this asymmetry can only be understood in a wider political context: on the one hand, out of a – historically quite understandable – fear of the increasing political weight and power of the freshly unified Germany, EMU in the beginning 1990s was intended to contain German economic dominance in Europe by replacing the D-Mark with a common European currency. On the other hand, however, European policy-makers (and citizens) at that time shied away from completing the process of European integration by establishing a political union ('United States of Europe') as well. As a result, the incomplete EMU poses not only the question of how national debt policies should be conducted. But more fundamentally, one also has to ask: are decentral fiscal policies, in the long run, consistent with a centralised monetary policy?

Given the institutional asymmetry described above, national debt policies in the EMU are faced with a delicate balancing act between two conflicting concerns: on the one hand, national governments, having abandoned monetary autonomy, are left only with the instruments of budgetary policy to deal with country-specific shocks and other short-term economic calamities that the ECB will not take care of. In such an environment, the standard economic targets-and-instruments framework suggests that national debt policies should be as flexible and autonomous as possible in the short run. On the other hand, the unsound public finances of member states make themselves for potential sources of economic disturbances, hindering the proper implementation of European monetary policy and jeopardizing the objectives of adequate growth, full employment and price stability; according to this line of reasoning, it is of prime importance to effectively constrain national debt policies in line with long-run requirements of fiscal discipline. This trade-off between short-term flexibility and the long-term constraints of national debt policies is one key issue in the design of the future European governance structure in the area of public finance.

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National debt policies in the short run: stability concerns

As emphasised by the theory of optimum currency areas (Mundell 1961; McKinnon 1963), the single most important cost of monetary unification is the abandonment of the nominal exchange rate as a policy instrument of international adjustment. The magnitude of this cost is determined by the nature of the macroeconomic shocks the common currency area is hit by: with respect to symmetric shocks the loss of the exchange-rate policy instrument can be more easily absorbed (although even in such cases the problem arises that the outside exchange rate is not determined efficiently). But when countries are hit by asymmetric shocks, i.e. changes in the exogenous set of economic data that hit different member countries each in a significantly different way, these shocks, by their very nature, cannot be neutralized by a common monetary policy, nor can member countries any longer use the exchange rate to correct for differential economic developments; this is the core macroeconomic problem of monetary unions (see e.g. Cohen and Wyplosz 1989).

It is true that, even in such events, decentral fiscal policy by national budgets would not be necessary if the adjustment of region-specific shocks occurred mainly

through the migration of workers, real-wage flexibility, or a system of federal taxes and budgetary transfers that automatically shifts resources from member-states where output expands towards jurisdictions suffering negative region-specific shocks.[1] However, with serious real-wage rigidities, limited intra-European labour mobility and a small-scale EU transfer-system geared towards structural differences, not stabilisation objectives, there does not appear to be scope in the Eurozone for sufficient adjustment on either margin. As a result, member states in Euroland are left only with the policy instruments of national budgets to deal with asymmetric temporary demand shocks and other short-run economic disturbances. Accordingly, when a member country is hit by a recession, it should at least enjoy the freedom to let its deficit increase through the automatic stabilisers built into its national budget. Under special circumstances like, for example, an unusually severe recession, member states should also be able to finance discretionary spending increases or tax reductions by issuing government debt.

National debt policies in the long run: fiscal discipline

In the long run, national debt policy is restricted by the government's intertemporal budget constraint. The government is solvent as long as the present value of its expected terminal net liabilities is zero (see Buiter 1985). If public sector debt is not eventually to be monetized, this implies that the present value of future taxes must be equal to the present value of future government spending plus the value of already outstanding government debt; thus, at any point in time, when the government has positive outstanding debt, it must anticipate running primary surpluses at some point in the future.

Forsaking monetary independence in a monetary union tightens the government budget constraint of Eurozone member states by limiting the availability of seigniorage revenues. Integration of goods and factor markets in the EU restricts the range of feasible national fiscal policies even further: a government's ability to borrow today is limited by its ability to tax tomorrow. And with capital and labour freely mobile within the economic union, any government's ability to tax tomorrow is, in turn, severely limited since an increasing tax burden may induce mobile factors of production to flee to lower-tax jurisdictions, eroding the tax base. Furthermore, as the recent European fiscal crisis has convincingly demonstrated, the issue of fiscal discipline takes on a new dramatic dimension in an incomplete monetary union like EMU. Without budgetary union, national governments in EMU are forced to issue debt in euros – a currency they do not control. But issuing debt in a currency they have no control over effectively transforms the long-run inter-temporal budget constraints of national governments into liquidity constraints that national governments have to face in the short or even very short run. These liquidity constraints make national governments quite dependent upon capital market investors and their expectations, which are not only irrationally shifting sometimes, but also tend to be self-fulfilling in nature. Consequently, national debt policies in a monetary union come with the risk that national governments are forced to default on their debt by self-fulfilling capital market expectations (see De Grauwe 2012).

Accordingly, with respect to national debt policies in the long run, the central challenge for the EMU is to find a practical arrangement that constrains national budgetary policies in line with the requirement of *fiscal discipline* – defined as sound and sustainable budgetary positions – so as to avoid acute liquidity crises in the sovereign debt market, as well as pressures for monetary accommodation by the ECB or bailout by other EU member states. Unfavourably, however, fiscal discipline is particularly precarious in Euroland because an incomplete monetary union strengthens existing incentives – of both an economic and politico-economic nature– for excessive national deficits.

Incentives for excessive deficits in a monetary union

The creation of a monetary union allows individual countries to shift an increasing share of their deficit financing costs to partner countries. Such negative pecuniary externalities of public debt are conceivable in various forms: in the first place, the creation of the EMU has enhanced intra-EU capital mobility, thereby reinforcing adverse spill-over effects associated with expansionary budget policies. A second line of reasoning focuses on moral hazard in a monetary union: individual member countries may be tempted to raise public debt beyond levels considered sustainable because they can expect the Union to come to their rescue, should a debt crisis emerge. Thirdly and finally, a certain degree of free-riding by the EMU member

[1] In 1957, Scitocsky already listed not only 'an all-European integrated capital market' but also 'an all-European integrated employment policy' as 'necessary conditions of currency union'.

countries[2] can be expected since political responsibility for price stability lies solely with the ECB as the only federal authority of economic policy, even if, de facto, the dangers to price stability are caused by unsound public finances.

The changes described in economic incentives through a monetary union might work hand-in-hand with already existing *political* distortions that give rise to a deficit bias and produce budgetary policies that are excessively expansionary from the standpoint of both inter-temporal efficiency and intergenerational equity. In particular, a monetary union tends to reduce the cost of borrowing as perceived by the government in power for two reasons: firstly, growing financial integration allows governments to borrow substantial amounts without having to face sharply rising interest rates; secondly, fixed nominal exchange rates among members of a monetary union remove the highly visible sanction of exchange-rate depreciation.

Disciplinary forces of international capital markets

If international capital markets worked efficiently, market forces in EMU could be expected to enhance fiscal discipline. As a member country's debt-to-GDP ratio rises, so should the required rate of return on public obligations, thus deterring from excessive borrowing. If they fail to heed the rise in interest rates, governments should find themselves rationed out of the market. If investors are able to distinguish good from bad credit risks, consequences should, furthermore, be limited to the member country running excessive deficits. Thus, if the capital markets worked efficiently, there would be no spill-overs, providing no motivation for a central bank bailout and no inflationary threat. That is: *if.* Practical experience with capital market assessments of default risks on the government bonds of countries during the recent debt crisis in Europe casts serious doubts on the idea of efficient markets. As a matter of fact, the markets did not seem to perceive any sign of excessive borrowing from countries like Greece, Ireland, Portugal, or Italy for a very long time. Until the year 2010, when suddenly and in a matter of weeks or even days, they started to attach huge risk premiums to the government bonds of the aforementioned countries, thereby transforming the long-run problem of government solvency in these countries into an acute liquidity crisis with strong self-fulfilling tendencies. As a bottom line, national fiscal policies cannot be expected to be adequately disciplined by international capital markets.

This leaves us, finally, with formal political rules on government budget deficits, such as Article 104c of the Maastricht Treaty, the Stability and Growth Pact and the European Fiscal Compact, that try to secure fiscal discipline by explicit budget rules and politically-imposed sanctions.

Disciplinary forces of explicit budget rules

In general, empirical evidence about existing rules on government budget deficits suggests that it is very difficult to enforce them (see von Hagen 1991). Furthermore, off-budgeting techniques, 'creative accounting' or even outright misreporting of budget numbers (e.g. in the case of Greece) were commonly used by EU member countries in the transition to monetary union as well as afterwards. Accordingly, the disciplinary force of the excessive deficit procedure laid down in Article 104c of the Maastricht Treaty appeared questionable from the start. After the launch of the EMU, the Treaty's original excessive deficit procedure has been put in more concrete terms by the so-called Stability and Growth Pact finally agreed upon at the 1997 summit of the European Council in Amsterdam. To date the Pact has been applied in a remarkably inconsistent manner. Furthermore, with its two reforms, it has been subjected to seesaw changes: in 2005, its rules were watered down under the pressure of Germany and France; while in 2011, following the 2010 European sovereign debt crisis, the EU member states adopted a new reform – now aimed at tightening the rules again.

In direct comparison, the most recent reform of the Stability and Growth Pact clearly strengthens the disciplinary force of the excessive deficit procedure: the procedure itself has been tightened and made more concrete, the sanctioning procedure has been made more automatic by a change in the voting procedure (switch to 'reverse majority voting') restricting the scope for strategic considerations in political decision-making processes, the Commission's power to obtain information from national governments has been increased and misreporting on deficits and debt can be penalized with a fine in the future.

European budget rules: an overall assessment

So far, we have discussed only the disciplinary effect of existing European budget rules. For an overall as-

[2] An extensive discussion of the associated risks of free-riding in the EMU can be found in Uhlig (2003).

sessment, however, one also has to keep in mind that the quest for fiscal discipline in the long run has to be balanced against the need for the flexibility of national debt policies in the short run. How do the existing European budget rules and procedures handle this delicate trade-off?

Quite obviously, the European fiscal rules and procedures are far more concerned about the long-run risks associated with national deficits and debt than about the opportunities associated with them in the short run. As a result, they end up being rather unbalanced and tend to focus on the long-run sustainability of national debt at the expense of the short-run flexibility of national budgetary policies. In doing so, the existing European rules and procedures on deficits and debt raise – at least – three major issues. Firstly, these provisions accept the risk that national budgets cannot adequately fulfil their roles as automatic stabilizers when member states are hit by asymmetric shocks, thereby potentially intensifying economic downturns. Secondly, the rigidity of existing European budgetary rules and sanctions also creates serious credibility issues with respect to its long-term sustainability goal. We have already seen in the (short) past of EMU (e.g. in 2002-2003 and again in the wake of the global financial crisis that started in 2008) that when their economies are hit by a recession, national governments are unwilling to subject their economies to deflationary policies and simply do not adhere to the Pact. As a result, the long-run provisions, while overly restrictive on paper on the one hand, have already lost most of their credibility – with the danger of turning the Pact, for all practical purposes, into a dead letter. Thirdly, as has been made very clear – again – in the course of the recent sovereign debt crisis, in times of economic calamities, the lack of balance between short- and long-term requirements for national debt policies in EMU also creates serious tensions between national governments and people, on the one hand, and European institutions, on the other hand. Among other things, it increases the pressure on both the ECB and the governments of other member states: on the former to loosen its monetary policy and bring about investment- and growth-enhancing interest rate, as well as to allow for explicit or implicit forms of monetary public debt financing; on the latter for higher transfer payments either to implicitly bail out the member states that are in financial distress or to soften the social consequences for their respective citizens.

All in all, therefore, in a paradoxical way, the lack of national debt-policy flexibility in the short run also magnifies the risk that the long-term goal of sound and sustainable public finances is missed.

European fiscal governance in the future

The current asymmetry of decentral fiscal policies pursued in a framework of centralised monetary policy, and not credible statutory restraints, is not a stable institutional arrangement. When hit by large asymmetric economic shocks, member states face serious adjustment problems and national governments push for transfer payments from the EU budget and/or other member states either to be implicitly bailed out of financial distress or to soften the social consequences of necessary adjustments.

What would an institutional arrangement that will alleviate these calamities look like? The straightforward solution from the viewpoint of macroeconomic stability would be the creation of a federal-type fiscal authority by centralising a substantial part of the national budgets at the EU level. This common union budget would serve two economic functions (see De Grauwe 2012): insurance against asymmetric shocks and protection from acute liquidity crises and forced defaults on sovereign debts.

Firstly, as the theory of optimum currency areas has pointed out, a system of federal taxes and budgetary transfers automatically shifts resources from member-states where output expands towards jurisdictions suffering negative region-specific shocks, thus smoothing consumption within each national economy and having a stabilising effect over time. This idea also played a major part in the 1977 MacDougall Report on the role of public finances in European integration, which concluded that EMU would not be viable without a sufficiently large community budget available for fiscal stabilisation policies. It has even been argued that monetary union would not survive in the absence of transfers to cushion shocks, since severe shocks would lead to defections (Sala-i-Martin and Sachs 1992).

Secondly, as outlined above, national debt policies in a monetary union come with the risk that national governments are forced to default on their debt by self-fulfilling capital market expectations. This risk can be eliminated by consolidating national debts into one common debt at the European level, i.e. by moving to

a budgetary union. The prospective EU government would issue debt in a currency over which it has full control and, accordingly, could not be confronted with the sort of liquidity crises several EU member states had to manage recently.

Of course, having a budgetary union together with a monetary union amounts to a European political superstructure, which is just short of a fully-fledged political union, making a giant leap towards a 'United States of Europe'.[3] So, finally, our discussion has come full circle: the issue of national debt policies in the EMU can only be resolved in a wider political context. The people of Europe and policy-makers have to make the fundamental decision they have been shying away from for over two decades: do we want a political union in Europe? If the answer is affirmative, then the move from an incomplete monetary union to a political union will also alleviate Eurozone governance problems with respect to national debt policies and macroeconomic stability.[4] If, on the other hand, the nation states that make up the EU and their respective citizens are not willing to transfer substantial parts of their national sovereignty (taxation and spending, in particular) to a European parliament and government, then it would, quite frankly, be only logical to unwind the monetary union as well. If EMU is to be continued in its present basic institutional set-up, there are some 'second-best' policy options (like Eurobonds, for instance, or improved coordination of macro-policies, etc.) that may fulfil at least some functions of a fully-fledged budgetary union. But the fiscal governance problems that come with the institutional asymmetry of an incomplete monetary union will continue to haunt the European Union and the most recent sovereign-debt crisis will almost certainly not be the last one.

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[3] Actually, US economists have seen the EMU as intermediate step to a political union. As Feldstein (1997, 60) points out: "while the individual governments and key political figures differ in their reasons for wanting a political union, there is no doubt that the real rationale for EMU is political and not economic".

[4] According to De Grauwe (2006), the EMU will stay a fragile regime as long as there is no political union. He bases his argument on three major issues: firstly, several important macroeconomic instruments have already been transferred to European institutions; secondly, there is no system of redistribution in Euroland that could help to deal with asymmetric negative shocks; and thirdly, since large parts of economic policy are still handled bay national governments, the risk of creating asymmetric shocks endangering stability prevails.