Institutions for Fiscal Stability in Europe

The Sustainability of Public Finances in the EMU

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The EMU and national fiscal policies

Membership in the European Monetary Union (EMU) has important consequences for national fiscal policies. Fiscal policy remains a national competence, but the EU and the EMU impose important constraints on its conduct. They arise from the wish to coordinate the policies of the member states and the need to maintain sustainable public finances. Coordination serves to improve the results of fiscal policy, but it is not a requirement for the proper functioning of the EMU. In contrast, maintaining sustainable public finances is a necessary condition for the EMU to function well and hold together. In the EU, coordination, which works primarily through the Broad Economic Policy Guidelines (BEPG) and several coordination procedures, relies on peer pressure and persuasion but not on formal sanctions.[1] The Euro Group, an informal meeting of the finance ministers of the EMU member states headed by a president elected for 2.5 years, serves to strengthen coordination in the euro area.

Sustainability is the focus of the Excessive Deficit Procedure (EDP, Art. 126 and Protocol No. 12 of the European Treaty) and the Stability and Growth Pact (SGP, Council Regulations 1466/97, 1476/97, Council Resolution 97/C236/01-02; Declaration on Art. 126), the rules of which can be enforced by formal sanctions and penalties. The treaty establishes "sound public finances" as one of the guiding principles of economic policy in the EU (Art 4(3)). Art 103 prohibits that the Community, its institutions, or individual member states may be held responsible for financial liabilities of other member states. This so-called "no-bailout clause" affirms that every member state, as a sovereign nation, is solely responsible for its own fiscal profligacy. However, the rule was broken in the course of the public debt crisis that started in 2010. As a result, the sustainability of public finances lost one of its legal cornerstones.

The euro and the intertemporal budget constraint

Economists generally equate "sound" with "sustainable" public finances, and interpret the latter in terms of the government's "intertemporal budget constraint" (IBC). This is the requirement that, in the long run, the present value of all future government spending including debt service cannot exceed the present value of all future government revenues. Sustainability does not rule out even long periods of large budget deficits, as long as these are compensated by future surpluses. Since the IBC extends over a long time horizon, sustainability does not have strong implications for current fiscal policies.

Due to the IBC, monetary and fiscal policies cannot be independent. One way to see this is that closing the gap between given expected streams of future expenditures and tax revenues may require printing more money than what a low-inflation policy would allow.[2] If governments fail to bring expenditures and tax revenues in line with the IBC, they will ask the ECB to buy government debt and print more money. The critical question then is, whether the ECB's institutional independence and its commitment to price stability are sufficiently strong for it to withstand such political pressures. The ECB's eagerness, during the European public debt crisis, to buy the debt of fiscally weak euro-area states has raised doubts about the answer to this question.

The "fiscal theory of the price level" (Leeper 1991; Cochrane 2011) sees the IBC as follows: The govern-

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[1] According to the Treaty on the European Union, member states regard their fiscal policies as a matter of common concern and coordinate them through the ECOFIN Council, the BEPG and the Mutual Surveillance Procedure (Art. 99, 121). For a review of policy coordination in the EMU, see Mundschenk and von Hagen (2002).

[2] For example, Sargent and Wallace (1981).

ment's total nominal obligations (money and bonds) outstanding divided by the price level must be equal to the expected present value of all future real government budget surpluses. If the former exceed the latter, inflationary pressures will push the price level up, until the real value of the government's obligations has decreased sufficiently. The additional insight of this theory is that by accumulating excessive debt fiscal policy can cause inflation in the EMU regardless of the ECB's independence.

Another way of looking at the IBC and the link between monetary and fiscal policy was not sufficiently understood until the European public debt crisis. For a government which can issue debt in its own currency inflation is the ultimate instrument to avoid sovereign default. All periods of high inflation in history were caused by unsustainable public debts. Creditors will protect themselves against expected inflation with higher nominal interest rates, which is why governments with weak public finances have to pay high inflation risk premiums on their debts – in the early 1990s, Greece paid over 20 percent interest on its public debt. With the adoption of the euro, interest rates on public debt converged to the low levels in Germany as investors perceived that the risk of inflation had diminished. What was not understood is that euro-denominated debt has some of the same properties as foreign-currency debt from the perspective of the borrower. By adopting the euro, governments surrendered their ultimate instrument to avoid default. For a given level of public debt, default risk increased. Investors can protect themselves against that risk by demanding higher interest rates. Thus, a higher default risk premium can replace a higher inflation risk premium in nominal interest rates. The euro is no guarantee for low interest rates on public debt unless that debt is sustainable. Obviously, this point was not recognized by the markets, which priced the debt of countries with weak public finances too much like that of countries with strong public finances, nor by the governments, which continued to borrow on a large scale, relying on the expectation that interest rates would remain low forever. With the onset of the crisis, however, markets began to price the debt of different states differently and bond yields now reflect the quality of the government as a debtor much more strongly (Schuknecht et al. 2011). Today, even after the violation of the no-bailout clause, Greece again pays close to 20 percent interest on its public debt. One may safely expect that sizeable risk premiums on government bonds will remain a feature of the euro-area bond market even when the debt crisis is over.

In the EMU, the IBC must hold at the union level, but not necessarily at the level of the individual country. A country might well be outside its IBC with no consequences for the stability of the euro, provided that the governments of the other member states are willing to pay transfers to this country or bail it out in the case of a fiscal crisis. Thus, the common currency creates a public-goods problem: its stability is maintained as long as all countries together adhere to the common IBC. An individual government might, therefore, relax its fiscal discipline with no consequences in terms of inflation. Therefore, the incentive to maintain sound public finances is weaker for a country inside the EMU than outside. The euro creates a moral hazard problem and there is a need for rules to preserve sound public finances in all member states.

Another way to look at this public-goods problem is to recognize that, with the adoption of the euro, countries have collectivized the instrument of last resort to avoid sovereign default, i.e., inflation. This has reduced the amount of debt each individual member state can assume without letting its default risk get too high. At the same time, however, the group as a whole can now use the inflation instrument to avoid default on a common debt. The euro has created a collective debt capacity which did not exist before. The economic value of this debt capacity is like a collective good, and in the absence of a euro-area government running its own fiscal policy it is up for grabs. Without realizing it (perhaps), the countries now receiving financial aid from the European rescue programs and the European Financial Stability Fund (EFSF) – Greece, Portugal, Ireland – were the first to grab for it. Proposals for a euro bond, i.e., a bond issued and guaranteed by all euro-area governments collectively, also reflect the existence of this common debt capacity. As in all collective-goods problems, however, there is a real risk that it will be overused and, ultimately, destroyed. There is a need for proper governance over it, including rules guaranteeing that it is used in ways deemed democratically acceptable and legitimate. It is unlikely that bailing out bankers who irresponsibly lent to weak governments would fulfill that condition.

The EDP and the SGP

The need for a framework which preserves sustainable public finances in the monetary union is the basic insight behind the EDP and the SGP. Since the

IBC relates to the long run, such a framework must not constrain fiscal policy too tightly in the short run. If it did, governments would try to circumvent the constraints and the framework would lose credibility. But it cannot be too lax in the short run either, because it would lose its bite in the long run as well. A proper framework must combine guidelines for short run budgetary policies with sound judgment concerning deviations from them to create a sufficient degree of flexibility.

This was the basic thrust of the EDP. It combines the unconditional obligation on the part of the member states to avoid "excessive deficits" with an assessment procedure for fiscal policies in the EMU. Specifically, the European Commission monitors budgetary developments in the member states, checking their compliance with reference values of three percent for the ratio of the deficit to GDP, and 60 percent for the ratio of public debt to GDP. If a member state does not comply with them, the Commission prepares a report to the ECOFIN Council, using its economic expertise and taking into account all relevant factors and circumstances. Based on this report and a Commission proposal, ECOFIN decides whether an excessive deficit exists. If so, ECOFIN asks the government concerned to correct the deficit and can enforce that decision with penalties.

The SGP was added to this framework in the late 1990s. It imposes a new and more ambitious medium-term budgetary objective of "close to balance or in surplus" on the member states and sets up an early warning system strengthening the surveillance of the public finances of the member states. This "preventive arm" of the SGP is based on EU Multilateral Surveillance and has lead to a complicated and elaborate system of fiscal reports and reports about reports that has been dubbed "government by statistics". The "dissuasive arm" of the SGP speeds up the EDP procedures and reduces the scope of economic judgment that the Commission can use in the assessment. As a result, the SGP has shifted the balance of power in favor of ECOFIN, which has reduced the credibility of the framework, since ECOFIN consists of the very politicians whose fiscal policies are to be judged. Furthermore, the SGP has created the perception that the fiscal framework of EMU was more rigid than it really is. This perception fuelled the opposition against the framework mounted by the German and other governments in 2002. This "SGP crisis" ended in a reform in 2005 that further weakened the framework.

In 1992, the EU's average debt ratio was almost 60 percent of GDP – hence the 60 percent limit foreseen in the Maastricht Treaty.[3] It climbed to almost 70 percent in 1997, the base year for the decision during which countries could enter the EMU. Between 1997 and 2007, the average debt ratio of the euro area (12 countries) fell slightly from 73 percent to 67 percent, mainly due to relatively favorable economic growth. It is projected to be 88 percent in 2011 and to continue to rise in the years that follow. Clearly, the fiscal framework of the EMU has not constrained public debt effectively. In fact, the fiscal performance of EU countries outside the euro area was significantly better than that of EU countries both before and during the financial crisis of 2008, a time when a strong fiscal framework was most needed and should have proven its effectiveness most clearly. "Government by statistics" in the euro area has failed.

Lessons from the European public debt crisis

The European public debt crisis started in October 2009, when the Greek government announced that its budget deficit stood at 12.9 percent of GDP rather than the 3.7 percent announced earlier. The difference was due to budgetary slippage, economic conditions and, importantly, creative accounting.[4] In the months that followed, rating agencies downgraded the debt of several euro-area countries including Greece, Portugal and even Spain, and interest rates on public debt rose sharply in several countries, reflecting the markets' fears that governments might turn out to be unable to service their debts. In April and May, Greece seemed to reach the point where markets were no longer willing to lend to the government even to roll over its existing debt.

European sovereign debt markets became increasingly volatile in the wake of the news about Greece and the mounting doubts about the credit quality of other euro-area countries. In an effort to calm markets and to prevent the public debt crisis from issuing into another banking crisis in Europe, the EU governments, with the assistance of the IMF, eventu-

[3] The 3 percent deficit limit under the EDP derives from the 60 percent debt limit assuming an average nominal GDP growth rate of five percent in all EMU member states.

[4] For the informed observer, the use of such practices by euro-area countries should not have been a surprise, although the sheer magnitude was perhaps astonishing. As documented by von Hagen and Wolff (2006), Brück and Stephan (2006), and Koen and van den Noord (2006), there is ample evidence of creative accounting in all EU-15 member states, and euro-area countries have shown a tendency to use creative accounting systematically to circumvent the three-percent deficit limit of the EDP since the start of the EMU.

ally decided on 23 April 2010, to set up a first rescue package for Greece of EUR 45 billion. As the effect of this package evaporated quickly, a second one of EUR 110 billion was agreed in early May. In June 2011, it turned out that the rescue packages had failed and another one worth EUR 109 billion was adopted. On 10 May 2010, the euro-area countries decided to set up the EUR 450 billion EFSF, which, together with a EUR 60 billion contribution from the European Commission and a EUR 250 billion contribution from the IMF, created the European Financial Stabilization Mechanism as a safety net for the debts of EU governments that might come under severe financial pressures.[5] The March 2011 European Council decided that this fund will become the permanent European Stability Mechanism in 2013. In the autumn of 2010, Ireland was brought under the ESFS umbrella, and, in the spring of 2011, Portugal.

The crisis has borne out several important lessons. The first is that the no-bailout clause was not credible, because there were no rules and guidelines for what to do when a euro-area country falls into a fiscal crisis. When the crisis was there, even breaking the EU Treaty seemed better to the politicians than letting Greece default. A second lesson is that, due to financial integration in the euro area, large portions of unsustainable public debts are held outside the borrowing country (Darvas et al. 2011). A country's public debt crisis, therefore, has significant financial market repercussions in other euro-area countries. A third lesson is that a public debt crisis in the euro area makes the ECB's operating framework for monetary policy dysfunctional, since it relies predominantly on loans to financial institutions collateralized with public debt. The ECB was eager to come into the rescue game for Greece seeking to protect its operating system, but in doing so maneuvered itself into a position that undermines its independence. The last lesson still remains to be acknowledged. This is that unsustainable debt is really unsustainable. Economic projections suggest that the Greek debt problem cannot be solved by lending more money to the government (Darvas et al. 2011). The stock of existing debt is simply too large for that. The real question now is, who will bear the cost of reducing the country's debt to a sustainable level, its creditors both in Greece and outside, or the tax payers of other euro-area countries. The longer this question remains unanswered, the more painful the solution will be in the end.

[5] http://www.efsf.europa.eu/

Proposed solutions: what will work and what won't

The European public debt crisis has lead to a number of proposals for solutions and reforms of the fiscal framework of the EMU. Some of these have no prospect for achieving anything, others seem more promising. Unfortunately, the governments have so far focused and agreed on the former type of proposals.

More government by statistics

The committee headed by the president of the European Council, Mr. van Rompuy, submitted a set of proposals in late 2010, which were later endorsed by the European Council and welcomed by the European Commission.[6] The thrust of these proposals is to strengthen the SGP by introducing more "government by statistics". This is based on three elements:

1) increased transparency of the national fiscal frameworks of the member states including the introduction of a "European semester", i.e., a more tightly coordinated calendar for fiscal reports and the formulation of fiscal plans in the member states,
2) stricter rules to assure the compliance with medium-term budgetary objectives, and,
3) stronger enforcement by means of stricter financial penalties that can be imposed under a broader range of circumstances than before. Stronger enforcement is also sought to result from a "reversed qualified majority voting rule" according to which a recommendation by the Commission requesting a member state to correct its fiscal policy will be adopted unless it is rejected by qualified majority.

Improvements in the SGP may strengthen the functioning of the rules, but the failure of the SGP in the first decade of the euro raises doubts whether this is the right approach to maintaining sustainable public finances in the euro area. Furthermore, moves in that direction also carry important risks. The first is that speedier and more automatic sanctions will further reduce the scope for informed judgment on the part of the Commission and, hence, further develop the fiscal framework into a set of rules that rigidly regulate short-term fiscal policies. But, as explained above, this will ultimately make the framework less credible. Given that the concept of sustainability is necessarily somewhat elusive, the idea to measure compliance with it using an ever increasing range of statistical variables is not convincing. Once the crisis is over,

[6] See European Commission (2010a-e; 2011).

national governments and parliaments will increasingly dislike what they perceive as a growing tendency of the Commission to meddle with internal affairs that its bureaucrats do not properly understand. As a result, they will seek and find ways to circumvent the framework.

The second risk is that, the more the EU – via the Commission – becomes involved in a country's fiscal and economic policies, the more it will be made responsible for any fiscal problems that might arise. National governments will perceive that they have a right to receive financial assistance from the EU in times of fiscal stress, arguing that they were doing what the EU told them to do. Further moral hazard problems will emerge as a result. Governments expecting assistance from the EU in times of economic difficulties will be less cautious in their own economic policies. More and increasing demands for bailouts and other forms of transfers will follow.

Fiscal councils

Some recent proposals call for the creation of independent fiscal agencies to monitor national fiscal policies and, possibly, an independent fiscal agency located within the European Commission to supervise fiscal developments in the euro area.[7] These proposals are based on similar ones made earlier in the academic debate (Harden and von Hagen 1994; Fatás et al. 2003; Jonung and Larch 2006). These authors suggest that the task of monitoring the sustainability of national fiscal policies should be delegated to independent agencies – fiscal councils or stability councils – which could be created both at the national level and at the level of the euro area. Economists from the IMF (Annett 2006; Annett et al. 2005) have recommended the creation of national fiscal councils as part of a strategy to strengthen the SGP. Leeper (2009) argues that fiscal councils could play a useful role in guiding public expectations about future fiscal policies. Fiscal institutions of this kind exist in a number of EU countries, among them the Netherlands, Belgium, Hungary, Austria, Romania and Sweden.[8]

The ideal fiscal council would be a politically independent actor involved in the national budget process with the right to determine the annual maximum allowable deficit for the country as a whole and to impose across-the-board spending cuts if the government did not comply with this limit (Harden and von Hagen 1994). A weaker version would be a fiscal council that comments publicly on fiscal policies and engages the government in a public debate about its policies. Fiscal councils can do much to improve the transparency of fiscal plans and frameworks without relying on heavy statistical machinery like the Commission. In doing so, they would contribute to strengthening the EDP and the SGP at the national level.

A permanent stability mechanism

A permanent European Stability Mechanism (ESM) endowed with financial contributions from the euro-area member states and with the right to issue its own bonds to finance purchases of distressed government bonds in the euro area would be a clear embodiment of the joint borrowing capacity created by the euro for the group of euro-area countries. As discussed above, such a fund creates a public-goods problem resulting in adverse incentives for fiscal policies in the euro area. Governments that can rely on being bailed out in fiscal crises have less need to behave prudently. The ESM will therefore weaken fiscal discipline in the euro area, unless using it were so painful for the borrower that governments would shy away from it. This, however, seems unlikely given that the ESM is an institution ruled by the governments.

Even if its base funding seems large, the capacity of the ESM to bail out individual countries will remain limited to the smaller euro-area countries. The public debts of the larger countries like Spain or Italy are simply too large even for Germany and France to shoulder. Furthermore, current developments already raise doubts about the participation of Italy and Spain in the funding of the ESM, since these two countries have their own problems with high debts. This effectively leaves Germany and France as the countries to provide the financing for the ESM. If this is the case, these two countries will want to determine the conditions for bailouts and financial assistance, and severely curtail the freedom of the countries receiving financial assistance to choose their own fiscal policies, while the latter will continuously complain about the loss of sovereignty they suffer. Although the euro itself is the most supranational element of European integration so far, the instrument preserving its stability would be purely intergovernmental and pit a few contributing states against the receiving ones. It is far from obvious that the euro could survive the resulting political and economic tensions.

[7] See, e.g., ECB (2010).
[8] See von Hagen (2010) for a review of the experience with fiscal councils.

A debt resolution mechanism

A permanent ESM would imply that the no-bailout principle has been completely thrown out. As argued above, the member governments did not hold to this principle at the beginning of the European public debt crisis, because there were no guidelines for sovereign default, which was thought to be impossible. Reinstating the principle requires developing a framework for the orderly default of public debtors. A number of proposals for that purpose exist, the idea going back to the debt crises in South-East Asia, Russia, and Latin America around the turn of the century.[9]

Sovereign defaults differ from private defaults in a number of ways. First, in contrast to a private company, a sovereign cannot be dissolved, and a forced liquidation of its assets is nowadays impossible. Second, while a private bankruptcy procedure primarily aims at maximizing the value the creditors can extract from the defaulting institution, a defaulting government must be left with the financial means to perform at least minimal functions of government. Third, governments cannot be put under receivership, as this would contradict the nature of democracy. Fourth, a sovereign's main asset is its power to tax, and the economic value of this asset depends on the quality of the administration and the loyalty of its citizens. Imposing administrative oversight from the outside might also destroy the value of this asset.

These differences imply that the instruments to deal with sovereign default in an orderly way are more limited than in the case of private default. They amount to finding an orderly process of restructuring a government's debt by negotiating with its creditors. The Paris Club (involving sovereign lenders) and the London Club (involving international banks) provide examples. In the European public debt crisis, where most of the debt is in the form of bonds, neither club would be appropriate. Instead, the euro area needs rules for orderly defaults of sovereign deborts guiding the necessary steps and market expectations.

A framework for sovereign default in the euro area would have to have four main elements. First, a mechanism to initiate default procedures. Its rules should be conducive to engaging early on creditors and debtors in an exchange of information and views on the current situation to reduce the uncertainty of the creditors (Krueger 2002). Given the potentially large number of creditors and that the debtor is a sovereign, the initiative to start bankruptcy procedures can only come from the debtor government. To reduce the moral hazard problem of unilateral debt repudiation, it could be required that the defaulting government file for default before a special chamber of the European Court of Justice (ECJ).

Second, a mechanism to prevent a minority of bondholders from exploiting the majority by refusing to agree to a restructuring of the debt in the hope that the majority would buy them out. This means that a super majority of bondholders would be able to force the minority to accept an agreement with the debtor country regarding the restructuring of its debt.

Third, a mechanism to conduct negotiations. An institution is required to invite the creditors to negotiations. In the context of sovereign bankruptcy, the sheer size of the task implies that this role would have to be assumed by a public institution or a large accounting firm. Furthermore, the valid claims on the defaulting government must be registered and a representative of the bondholders appointed. A special chamber of the ECJ could handle these tasks. Finally, a court having final and complete jurisdiction over the case must be determined, and this court would have to declare the settlement between the creditors and the sovereign borrower as binding for all parties involved. Again, the ECJ could serve that purpose.

Creating such a framework would acknowledge that sovereign default is possible for governments with unsustainable debts in the euro area. It would make financial investors responsible for lending to governments with unsustainable debt and thus strengthen the incentives for investors to monitor the fiscal performance of the governments they lend to. This would strengthen market discipline and the governments' incentives to behave in financially responsible ways. Importantly, banking regulation such as the Basle rules would have to be adjusted to acknowledge that sovereign debt is not risk free. The EU might still provide financial assistance to a country to help it get over liquidity problems after a settlement with its creditors has been reached. This would make economic sense given that the sustainability of the country's public finances has been restored by the settlement.

[9] See Bucheit and Gulati (2010), Gros and Mayer (2010a, b), Gianviti et al. (2010), Krueger (2002), Rogoff and Zettelmeyer (2002) and Thomas (2004).

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