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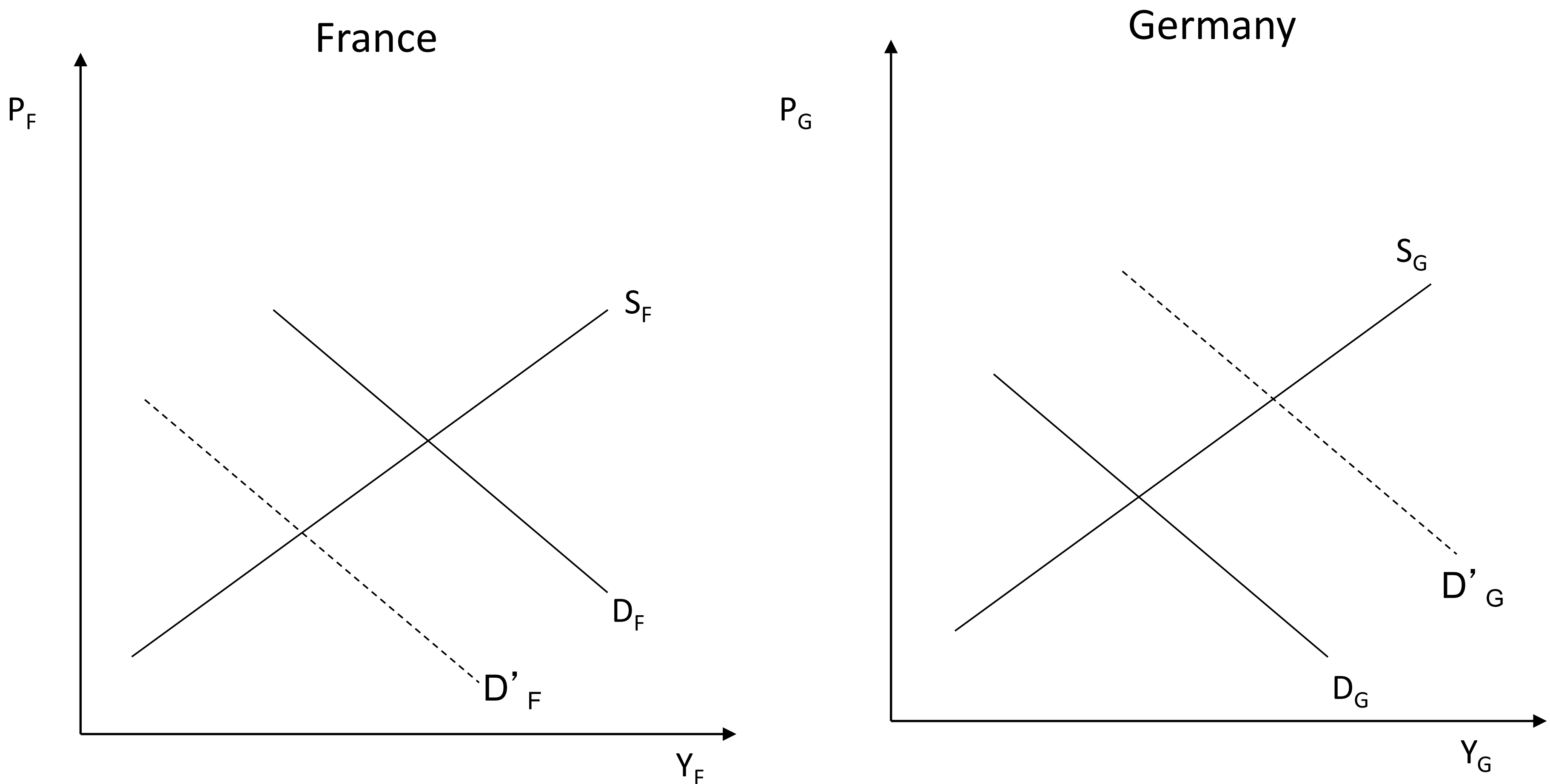
Economics of Monetary Union
12e

Chapter 11: Fiscal Policies in Monetary Unions

Fiscal policies and the theory of optimum currency areas

Figure 10.1 Asymmetric shock in France and Germany



Two cases:

- France and Germany form monetary and budgetary union
- France and Germany form a monetary union without budgetary union

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France and Germany form monetary and budgetary union

- Centralized budget works as insurance mechanism
  - if asymmetric shock occurs
  - the centralized European budget automatically redistributes income from Germany to France
  - there is risk sharing
- Centralized budget reduces fragility
  - Centralization implies that the European government issues common bonds.
  - This is situation of “stand-alone” countries which, issue their in currency over which they have full control

France and Germany do not form budgetary union

- Insurance mechanism through integrated bond markets
  – if asymmetric shock occurs
  – France accumulates budget deficits and debt
  – Germany reduces deficits and debt
  – if capital markets are integrated French government borrowing eased by increased German supply of savings

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- Insurance fails
  - if distrust prevails
  - Then destabilizing capital flows
  - Countries are pushed in bad equilibrium
  - Markets fail to provide insurance

- Need to centralize the budget depends on the nature of the shocks.
- If these are primarily of the endogenous type the need to have a centralized budget to deal with these shocks is strong.
  - When asymmetric shocks occur as a result of unsynchronized business cycles flexibility is not the answer.
  - Instead and insurance mechanism provided by a central budget is called for.

- In contrast, when the asymmetric shocks are exogenous the focus should be on flexibility.
  - Insurance can only be used as a temporary device to alleviate the cost of adjustment.
  - We have given this view a graphical interpretation in Figure 4.8 (see chapter 4).

- The theory of optimum currency areas leads to the following implications:
  - It is desirable to centralize a significant part of the national budgets to the European level.
  - Risk sharing reduces social costs of a monetary union.
  - If such a centralization of the national government budgets in a monetary union is not possible:
  - then, national fiscal policies should be used in a flexible way and national budgetary authorities should enjoy autonomy.

- The view expressed in the OCA-theory has not prevailed.
- Instead rigid rules have been imposed.
- These find origin in the view that the systematic use of fiscal policies can lead to unsustainable debts and deficits.

Sustainability of government budget deficits

- A budget deficit leads to an increase in government debt which will have to be serviced in the future.
- Government budget constraint:

$$G - T + rB = \mathrm{d}B/\mathrm{d}t + \mathrm{d}M/\mathrm{d}t$$

  - G is the level of government spending (excluding interest payments on the government debt), T is the tax revenue, r is the interest rate on the government debt, B, and M is the level of high-powered money (monetary base).
  - (G - T) is the primary budget deficit, rB is the interest payment on the government debt .
  - The budget deficit can be financed by issuing debt (dB/dt) or by issuing high-powered money dM/dt.

The dynamics of debt accumulation

$$\dot{b} = (g - t) + (r - x)b - \dot{m}$$

- where g = G/Y, t = T/Y, x = Y/Y (the growth rate of GDP), and b=B/Y

$$\dot{m} = \dot{M} / Y$$

- When the interest rate on government debt exceeds the growth rate of GDP, the debt-to-GDP ratio will increase without bounds (“Ponzi game”).
- The dynamics of debt accumulation can only be stopped if the primary budget deficit (as a percentage of GDP) turns into a surplus.
- Alternatively, it can be stopped by seigniorage.

- The debt-to-GDP ratio stabilizes at a constant value if

$$(r-x)b=(t-g)-\dot{m}$$

- If nominal interest rate > the nominal growth rate of the economy,
  - either the primary budget shows a sufficiently high surplus (*t* > *g*)
  - or money creation is sufficiently high in order to stabilize the debt - GDP ratio.
  - The latter option has been chosen by many Latin American countries during the 1980s, and more recently by some Eastern European countries. It has also led to hyperinflation in these countries.

- Important conclusion is that, if a country has accumulated sizeable deficits in the past, it will now have to run large primary budget surpluses in order to prevent the debt - GDP ratio from increasing automatically.
- This means that the country will have to reduce spending and/or increase taxes.

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Figure 11.2 Government Budget Deficits in Belgium, The Netherlands, and Italy (1979 – 2007)

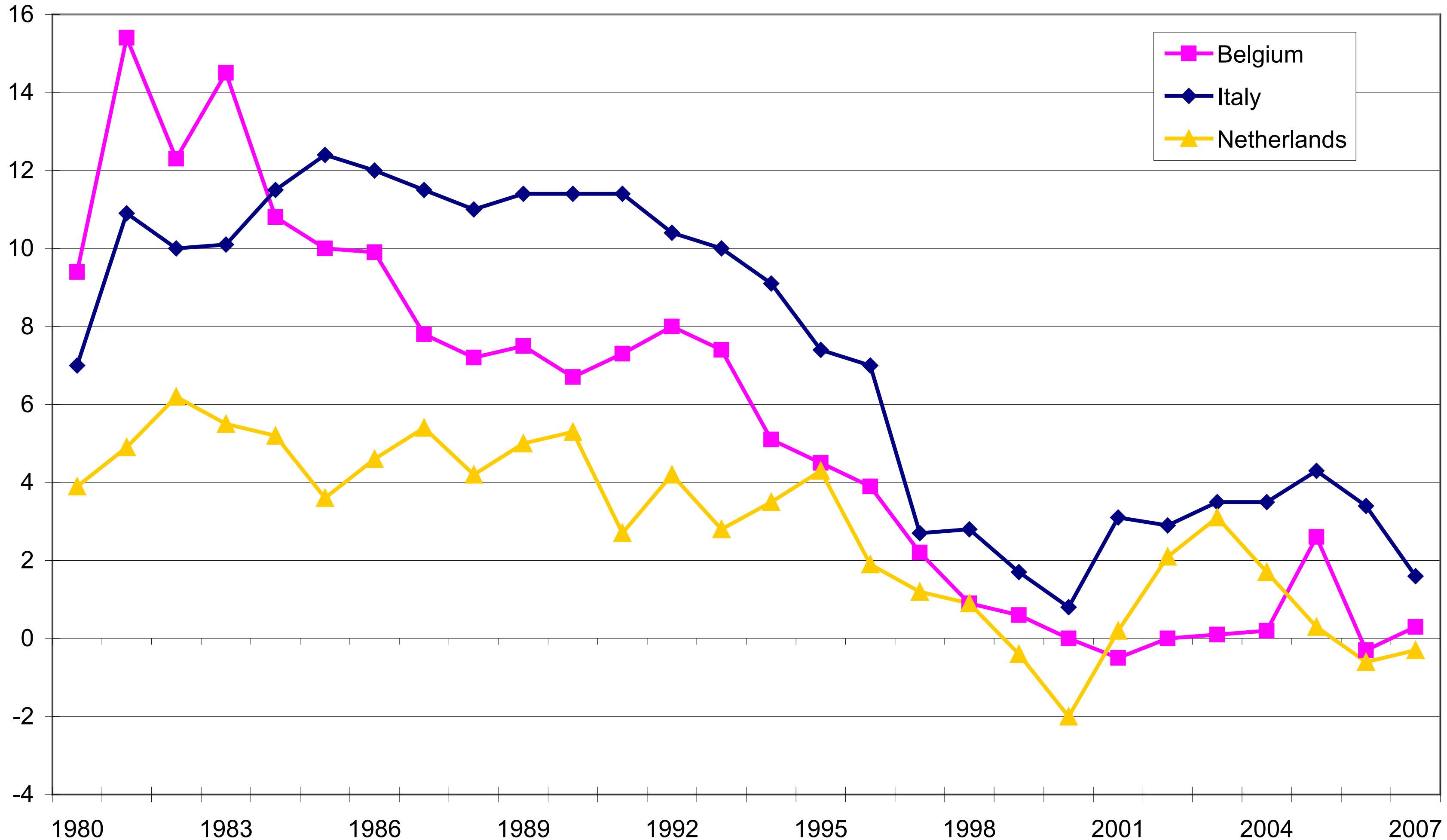

Figure 11.3 Gross Public Debt (% of GDP)

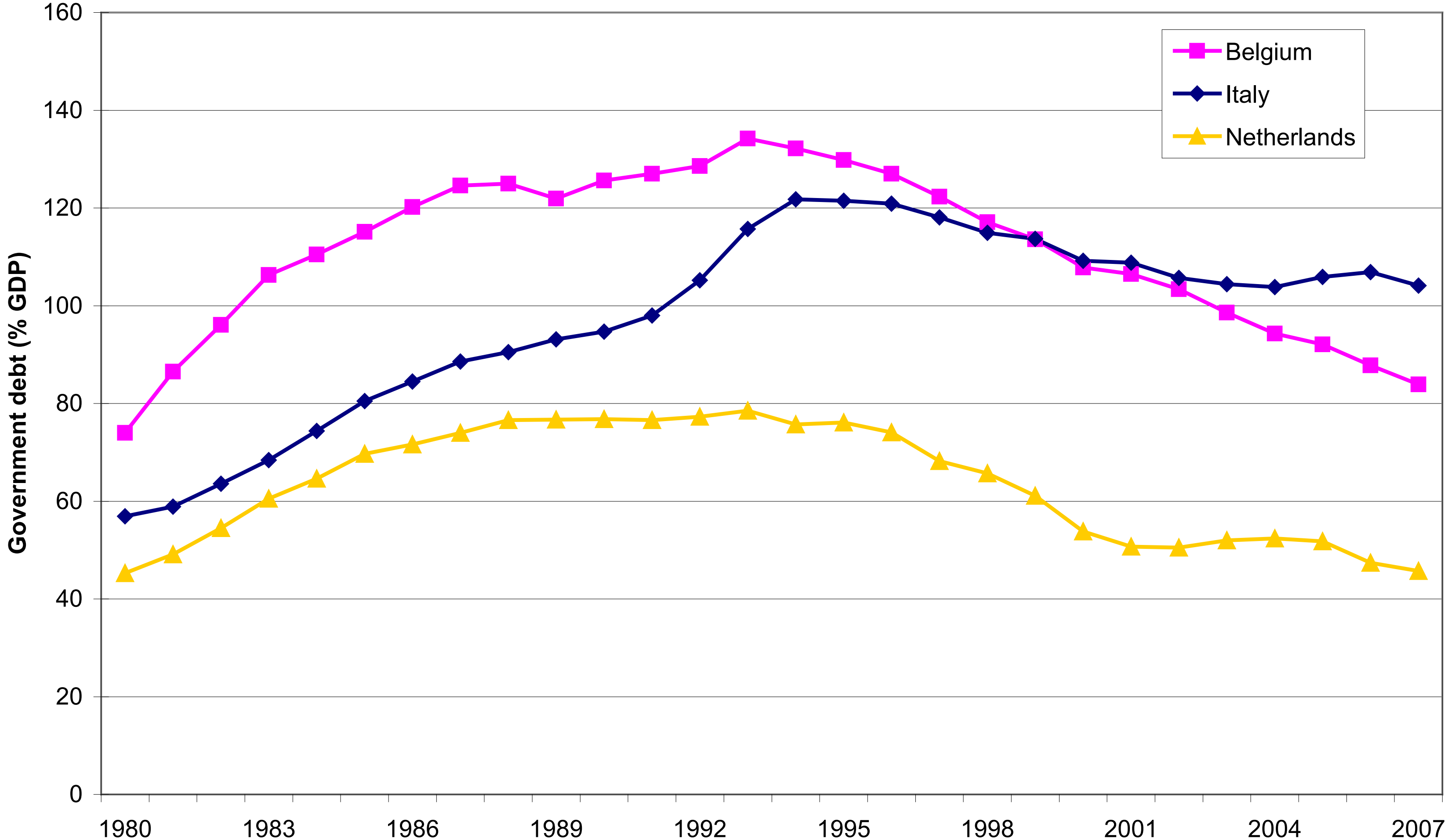

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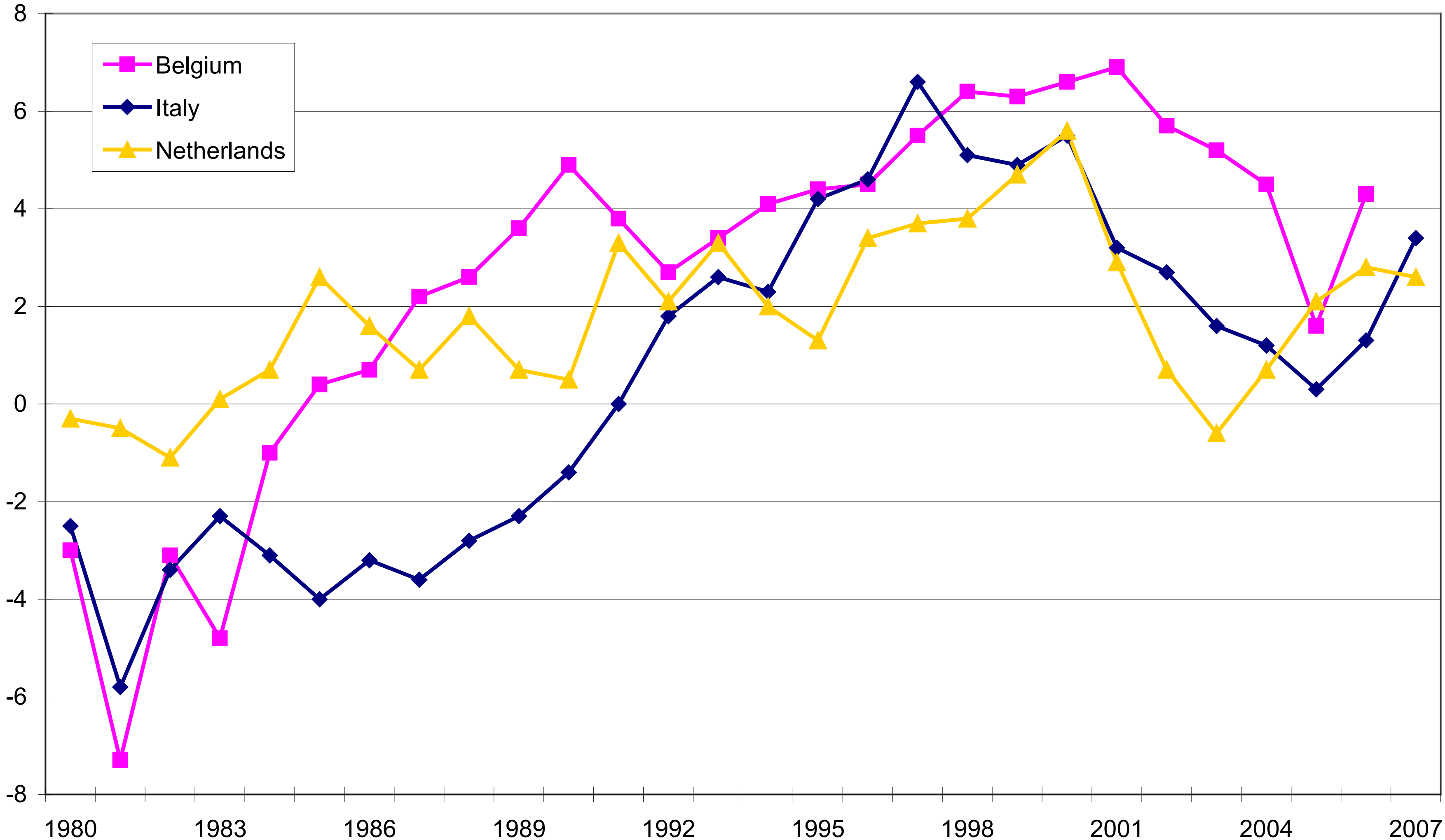
Figure 11.4 Government budget surplus, excluding interest payments (% of GDP)



- The experience of these countries shows that large government budget deficits quickly lead to an unsustainable debt dynamics.
- Fiscal policies are not the flexible instrument.
- There is a lot of inertia.
- The systematic use of this instrument leads to problems of sustainability, which forces countries to run budget surpluses for a number of years.

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Stability and Growth Pact

- Main principles
  - Countries have to achieve balanced budgets over the business cycle.
  - Countries with a budget deficit > 3% of GDP will be subject to fines. These fines can reach up to 0.5% of GDP.
  - These fines will not be applied if the countries in question experiences exceptional circumstances, e.g. a natural disaster or a decline of their GDP of more than 2% during one year.
  - In cases where the drop in GDP is between 0.75 and 2% the application of the fine will be subject to the approval of the EU finance ministers.

Sovereign debt crisis and fiscal discipline

- As a result of debt crisis in Eurozone fiscal discipline is reinforced
- German proposal: Fiscal Compact
  - i.e. member countries must embed in national legislation a balanced budget rule
  - Note: this is balance in structural budget
  - Not very different from Stability Pact
- Sanctioning mechanism in Stability Pact is reinforced by use of “Reverse Qualified Majority” making sanctioning quasi-automatic

The argument for rules on government budget deficits

- A country with an unsustainable increasing government debt creates negative spillover effects for the rest of the monetary union.
- First, such a country will have increasing recourse to the capital markets of the union
  - The union interest rate increases.
  - This higher union interest rate increases the burden of the government debts of the other countries.
  - These will be forced to follow more restrictive fiscal policies.

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- A second spillover :
  - The upward movement of the union interest rate is likely to put pressure on the ECB to relax its monetary policy stance.

Criticism is based on efficient markets

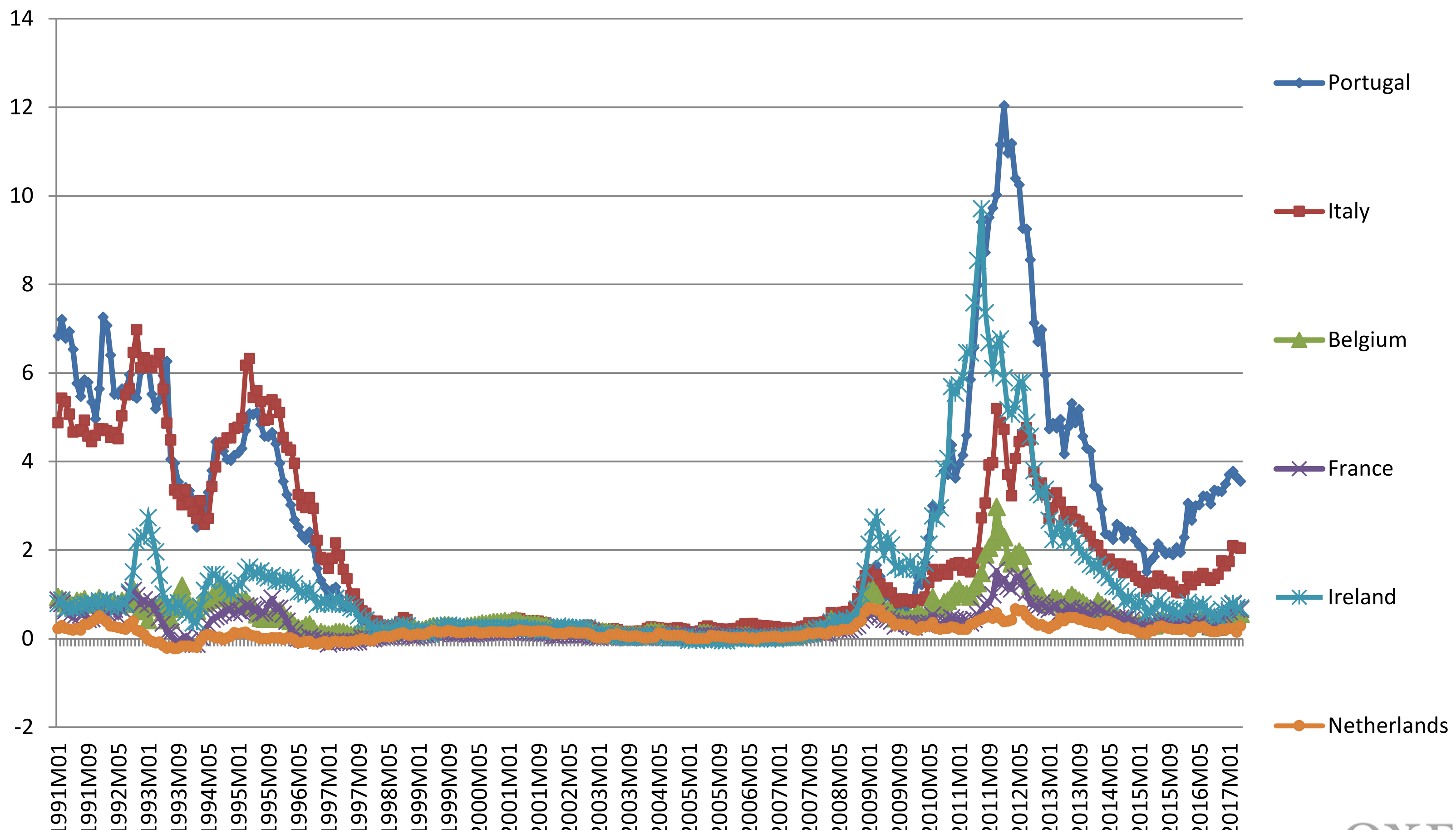
- If the capital markets work efficiently, there will be no spillover:
  - There will be different interest rates in the union, reflecting different risk premia on the government debt of the union members.
  - It does not make sense to talk about *the* union interest rate.

Is this criticism valid?

- There is interdependence in the risk of bonds issued by different governments because within EMU, governments are likely to bail out a defaulting member state.
- Thus, financial markets may find it difficult to price these risks correctly.
- The ‘no-bailout’ clause introduced in the Maastricht Treaty may not be credible.
- Mutual control to avoid costly bailouts is necessary.

Have financial markets correctly priced risk in government bond markets?

Figure 11.5 Spreads of 10-year government bond rates vis-à-vis Germany (1991–2015).



Source: Eurostat

- During the 1990s spreads were significant but declining.
  - most convincing explanation: during pre-Eurozone period devaluation risk (vis-à-vis the German mark) was most important source of the risk premium.
  - As the start of the Eurozone came nearer the risk of devaluation declined and so did the risk premium.
  - From 1999 devaluation risk disappeared and spreads dropped to zero

- During 2000-08 financial markets considered that investing in an Italian bond carried the same risk as investing in a German bond.
  - Markets perceived the default risk on Italian bonds to be the same as on German government bonds.
- In 2008 perceptions dramatically changed, and spreads increased and reached levels that were higher than during the 1990s.
- Thus, suddenly, the markets perceived huge default risks on the government bonds of countries like Ireland, Portugal, Greece, and Italy
- Then suddenly in 2012 these spreads declined dramatically again

Doubts about market efficiency

- During almost 10 years (1999-2008) financial markets did not perceive default risks on the government bonds of “peripheral countries”.
- Thus markets did not see any sign of the fragility in the Eurozone that we discussed in the previous chapters.
- Then suddenly, financial markets discovered this fragility in a matter of a few weeks and started to attach huge risk premia to the government bonds of peripheral countries.
- When the ECB announced OMT the fear factor was taken out of the market.

Fiscal discipline in monetary unions

- A monetary union may change the incentives of fiscal policy-makers, and, in so doing, may affect budgetary discipline.
- There are two opposing effects
  1. Once in monetary union, individual governments face a larger 'domestic' capital market; their capacity to borrow increases; this will lead them to borrow more, and to have larger deficits ("Common Pool" problem).

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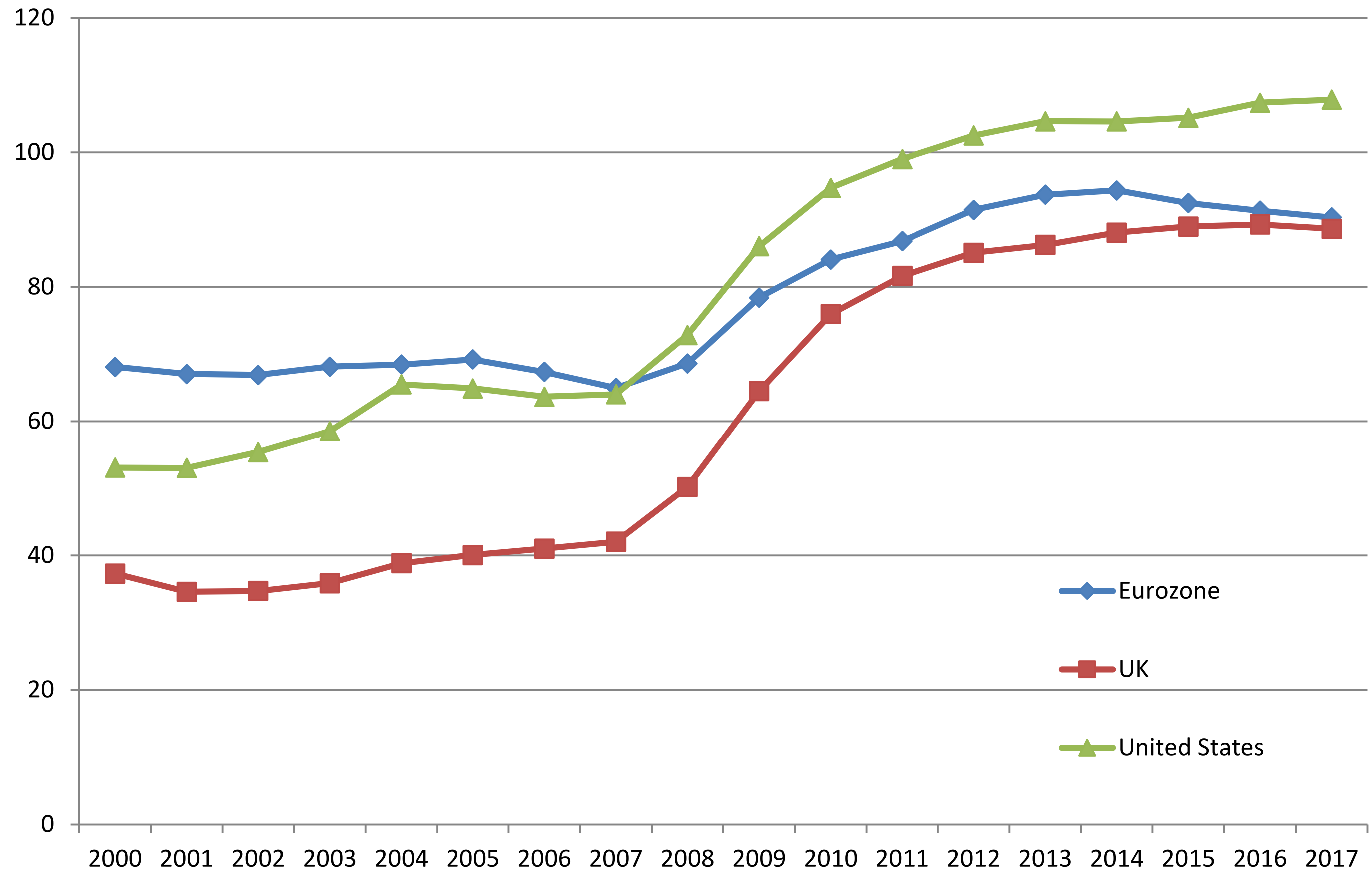
Fiscal discipline in monetary unions

2. Countries which join the union in a currency they have no control over reduce their ability to finance budget deficits by money creation.
    - As a result, the governments of member states of a monetary union face a 'harder' budget constraint than sovereign nations.
    - This will reduce budget deficits.

Figure 11.6 Government debt in the Eurozone, the USA, and the UK (% of GDP).



Source: European Commission, *AMECO*

Fiscal discipline in monetary unions

- No evidence of faster increase in the Eurozone government debt ratio as compared with the US and the UK.
- On the contrary, since 2000 these ratios have increased significantly faster in the US (+102%) and the UK (+139%) than in the Eurozone (+34%).
- Thus, the second (no-monetization) effect appears to play a stronger role than the moral hazard effect.
- Despite all this, Eurozone countries have experienced debt crisis, not the US and UK.

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The Stability and Growth Pact: an evaluation

- Two conflicting concerns.
  - The first one has to do with flexibility and is stressed in the theory of optimum currency areas: in the absence of the exchange rate instrument and a centralized European budget, national government budgets are the only available instruments for nation-states to confront asymmetric shocks.
  - A second concern relates to the spillover effects of unsustainable national debts and deficits.

The Stability and Growth Pact: an evaluation

- The Pact has been guided more by the fear of unsustainable debts and deficits than by the need for flexibility.
  - Pact is quite unbalanced in stressing the need for strict rules at the expense of flexibility.
  - This creates risk that capacity of national budgets to function as automatic stabilizers during recessions will be hampered,
  - thereby intensifying recessions.

The Stability and Growth Pact: an evaluation

- The flaws of the Stability and Growth Pact we just described led to serious problems in 2002– 4.
  - Major Eurozone countries were hit by an economic downturn. This led to an increase of the budget deficits of France, Germany, Italy, and Portugal.
  - In the name of the Pact, the European Commission insisted that these countries should return to budget balance even in the midst of a declining business cycle.
  - A number of countries, in particular France and Germany, refused to submit their economy to such deflationary policies.

The Stability and Growth Pact: an evaluation

- The result was a clash with European Commission which, as the guardian of the Pact, started procedures against these countries.
  - Commission had to yield to unwillingness of these countries to subject their policies towards the increasing number of unemployed to the rule of the mythical number 3.
  - In November 2003 the Council of Ministers abrogated the procedure that the European Commission had started.
- For all practical purposes the Pact had become a dead letter.

- The recession that started in 2008 and the ensuing increase in government budget deficits and debts started a new phase in the application of the Stability and Growth Pact.
  - The provisions of the Pact were tightened up again.
  - Sanctions will be made more automatic again, and the European Commission will have a stronger monitoring power.
- Whether this tightened up Stability Pact will be more successful in constraining the government budget deficits and debts remains to be seen.

Joint Eurobond issue

- By jointly issuing Eurobonds, participating countries become jointly liable for the debt they have issued together.
- This is a very visible and constraining commitment that can convince the markets that member countries are serious about the future of the euro.
- In addition, by pooling the issue of government bonds, the member countries protect themselves against the destabilizing liquidity crises that arise from their inability to control the currency in which their debt is issued.

Objections to Eurobonds

- The proposal of issuing common Eurobonds has met stiff resistance in a number of countries.
- This resistance is understandable.
- A common Eurobond creates a number of serious problems that have to be addressed.

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Moral hazard

- Common Eurobond issue contains an implicit insurance for the participating countries.
- Since countries are collectively responsible for the joint debt issue, an incentive is created for countries to rely on this implicit insurance and to issue too much debt.
- This creates a lot of resistance in the other countries that behave responsibly.
- This moral hazard risk should be resolved.

Unattractive for low risk countries

- A second problem arises low risk countries (Germany, Finland the Netherlands) profit from triple A ratings allowing them to obtain the best possible borrowing conditions.
- What are the benefits for these countries?
- It is not inconceivable that by joining a common bond mechanism that will include high risk countries, the low risk countries may actually have to pay a higher interest rate on their debt.

The design of common Eurobonds

- Should take care of these objections
- This can be achieved by working both on the quantities and the pricing of the Eurobonds
- A combination of :
  - Blue and red bonds (Bruegel): participation in common eurobond limited to given % of GDP (blue bond; senior); the rest is red bond (junior).
  - Differential interest rates (De Grauwe and Moesen): countries pay an interest rate related to fiscal position

Conclusion

- Two views about how national fiscal policies should be conducted in a monetary union.
  – national fiscal authorities should maintain a sufficient amount of flexibility and autonomy (theory of optimum currency areas).
  – the conduct of fiscal policies in the monetary union has to be disciplined by explicit rules on the size of the national budget deficits(Stability and Growth Pact).
- Strong criticism against the Stability and Growth Pact for its excessive rigidity

Conclusion

- As a result of sovereign debt crisis fiscal discipline has been reinforced even more
- Probably due to fact that financial markets have less patience with members of a monetary union than with “stand-alone” countries,
  - because former cannot give guarantee that the cash will always be available to pay out bondholders.
  - As a result, members of a monetary union are punished quicker by financial markets than “stand-alone” countries and can quickly be pushed into a situation in which they face unbearably high interest rates that in a self-fulfilling way drives them into default.

Conclusion

- Governments, like private companies, make investments that will profit future generations.
- It is desirable that these future generations share in the cost.
  - This is achieved by issuing debt.
  - What should be avoided is unsustainable debt levels, not debt per se.
  - Fiscal Pact disregards these principles
- As a result of the debt crisis the Stability and Growth Pact has been strengthened again.
- Whether this new Pact will work better than the previous one remains to be seen.