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ECONOMIC AND MONETARY AFFAIRS

High Deficits and Debts: What to Do About them?

NOTE

Abstract

A predicted consequence of the financial crisis and the ensuing recession is the emergence of deep budget deficits, which accummulate into large public debts. The present note makes the following points:

1. The debt buildup is historical by its size and its occurrence. Public debts must absolutely be brought down, but the effort should and will be spread over years, possibly decades.
2. Financial markets are over-reacting as the focus on a few countries, and this over-reaction may force governments to default. Bailing them out is legally wrong, economically unjustified and politically dangerous.
3. The debt crisis confirms that the Stability and Growth Pact has failed. The solution is not to make the Pact stricter and more intrusive but to require that every Euro area member has in place proper budgetary institutions.

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EXECUTIVE SUMMARY

The "Greek crisis" is creating the impression that budget deficits and public debts are out of control and that European governments are planning to default one after the other. Panicking markets and rating agencies have never provided a correct picture of the situation. No government is considering deliberately to default on its debt obligations and no government needs to. Defaults will only occur if forced by the markets.

No Euro area government has any reason to default both because they all have the resources needed to serve their debts and because a default would create enormously costly disruptions. Yet, it will take decades to bring public debts down to comfortable levels. No government can achieve this aim quickly because it would require either punitive taxes or highly painful cuts in public services. Nor should they attempt to do so, because it would exercise considerable contractionary pressure, which would again deepen the deficits that need to be closed. Because the crisis is one-in-several-generations, erasing its debt repercussion should be spread over several generations.

The evidence on the impact of deficits and debts on the interest rate is sketchy and the link between budget deficits and exchange rates is even more tenuous. The link is observed in crisis times, when markets simultaneously run on a public debt and on the country's currency.

History has demonstrated that inflation occurs when budget deficits run out of control. In Europe, in the absence of a federal arrangement, authority over budgetary matters remains at the national level. The Treaty seeks to alleviate the problem in two ways. First, the no bailout clause circumscribes budgetary issues at the national level, where the authority exclusively lies. Second, the Stability and Growth Pact is meant to prevent fiscal indiscipline.

The Greek debt crisis is the first time that the no-bailout clause becomes binding. At the time of writing, some governments look for ways to provide support to the Greek government. This would go against the spirit of the Treaty. To reduce the moral hazard thus created, governments and the Commission intend to impose tight conditions on Greece, but the EU has no instrument to impose budgetary conditions on a member government. Greece will not be able to fulfil what is demanded of her. The alternative to the bailout is to accept that the Greek government defaults. In that event, Greece would have to negotiate a deal with its creditors. During that time, being unable to borrow, the Greek government would have to balance its budget. For the rest of Europe, this would be a non-event. The simple way to avoid both the bailout and the default is to call in the IMF.

Fiscal discipline is the weak element in the current setup of the European monetary union. Experience and theory show that fiscal discipline can only be durably maintained when the budgetary institutions are designed to that effect. The solution cannot be to tighten the Stability and Growth Pact, because budgets are clearly part of national sovereignty. Fiscal discipline can only be imposed at the national level. Each Euro area member should adopt an institutional arrangement to be validated by the Commission. In this way, budgetary sovereignty can be preserved while the collective need for fiscal discipline is satisfied.

1. WHAT IS THE PROBLEM?

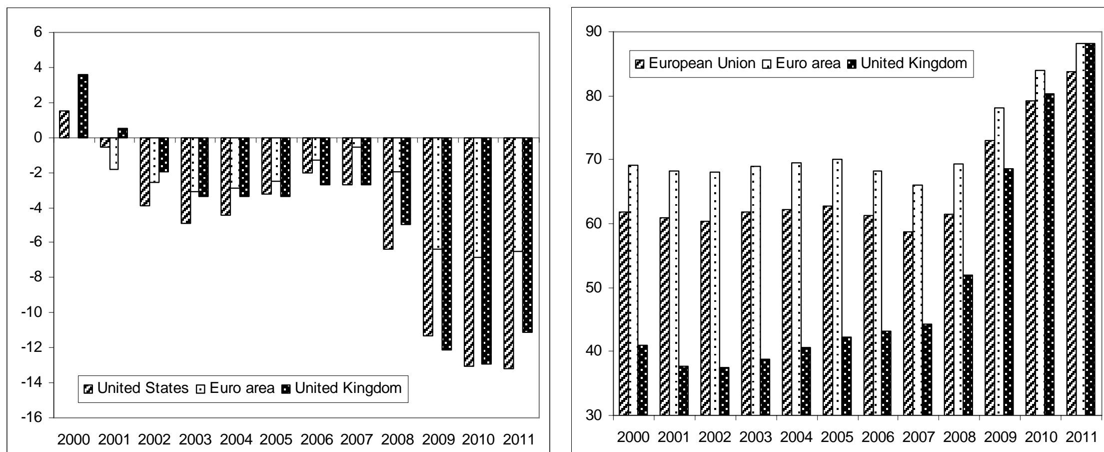
1.1. The raw numbers

There is nearly unanimous agreement that the fiscal positions of the developed countries is deteriorating in historical proportions. The figures below show, on the left, the budget balance and, on the right, the public debt of the Euro Area, of the US and of the UK, expressed as percent of GDP. The deterioration of deficits is remindful of the previous slowdown in 2001-2, but it is much deeper. The rise of public debts is not even comparable across both events, because this time we saw GDPs declining while before, and in moist post-war events, GDP growth merely slowed down but remained positive.

The figures also show the deterioration is also smaller in the Euro Area than in the two other countries. This is not because the recession was smaller in the Euro area: in 2009, its real GDP fell by 4.1%, more than in the US (2.5%) and slightly less than in the UK (4.7%). It is because most European governments have reacted much more conservatively to the financial crisis than the UK and the US (and other countries, including China). Yet, because of the recession, public debts have still increased in the Euro area. Current projections are that the debt will stand at 84% of GDP by the end of next year.

Figure 1. Fiscal policies

Budget balances (% of GDP) Public debts (% of GDP)



Source: AMECO, European Commission

1.2. A sober interpretation

The "Greek crisis" is creating the impression that budget deficits and public debts are out of control and that European governments are planning to default one after the other. Panicking markets and rating agencies have never provided a correct picture of the situation. No government is considering deliberately to default on its debt obligations and no government needs to. Defaults will only occur if forced by the markets.

The sharp deterioration of public finances was expected as soon as the extent of the crisis became visible.[1] The numbers are huge, but so was the crisis. If, as is currently hoped, the world recovers in 2010, it will be because both fiscal and monetary authorities have acted quickly and, in many cases, forcefully enough to break the depression spiral. Expressing concern about the deficits and likely evolution of public debts is at best naïve and at worst both outrageous and dangerous.

Because the fiscal deterioration is a consequence of the crisis, some improvement will occur spontaneously as the recovery firms up. Tax revenues will rise again and the extraordinary spending, inasmuch as it was temporary, will stop. But this will not be enough for three main reasons. First, for many years to come, GDP will likely be lower than it would have been otherwise, which will translate into lower tax revenues, while public spending will continue along its previous trend, thus opening a permanent gap. Second, spending will often be above its pre-crisis trend because some of the extraordinary spending has been mistakenly been permanent. Finally, debt service has increased.

Many countries are now saddled with highly uncomfortable debt levels. None of them is facing "bankruptcy" because governments cannot be closed down and because, in developed countries at least, governments can extract massive resources through taxation.[2] No Euro area government has any reason to default because they all have the taxing ability to raise enough resources to serve their debts and because a default would create enormously costly disruptions.

On the other hand, it will take decades to bring public debts down to comfortable levels. No government can achieve this aim quickly because it would require either punitive taxes or highly painful cuts in public services. Nor should they attempt to do so, because it would unleash considerable contractionary forces, which would again deepen the deficits that need to be closed. Because the crisis is one-in-several-generations, erasing its debt repercussion should be spread over several generations. The problem is not the debt level in 2012; rather it is that the debt level in 2007 was excessive in a number of countries, with no historical justification.

1.3. Clarification required

Barely three years ago, no one would have ever imagined that debt numbers would soon reach their currently anticipated levels. The debt build-up, which can reach 30% or more of GDP, is staggering, but it must be put in proper context: the debt figures shown above refer to the *gross* and *explicit* debt.

Gross means that public assets are not computed. Yet, all governments own assets, some of them highly marketable as they range from buildings to ownership rights in corporations. Gross debts may severely underestimate the financial situation of governments. It would be logical to look at net indebtedness but measuring all assets is notoriously difficult (e.g. what is the value of roads?) and, when attempted, highly imprecise, while only measuring some assets would inject unavoidable arbitrariness and undermine the credibility of the numbers.

Explicit debts refer to financial instruments (bills, bonds) issued by governments. In practice however, governments are committed to a host of spending items that represent

[1] See, for example, my special Report to the ECON Committee of early 2009.

[2] Iceland is one country whose obligations after the collapse of its two banks, if recognized, may exceed the resources that can be taxed away.

their implicit debt. Some of these commitments are even underpinned by legislation, for example unemployment insurance payments or pensions for retired people. Others are unavoidable payments, for example support in case of natural disasters or unfunded rescue of collapsing banks. These commitments are a special form of debt. They are often called contingent liabilities to recognize that payments depend on the realization of some event.

In many countries, the pension system is not fully-funded. This implies that the state will have to pay people when they retire, and as long as they live. The demographic transition implies that over the next decades, payments to retired people will expand while the resources levied on active people will decline. Unfortunately, official estimates of the corresponding implicit debt are not available. Very rough estimates show that, in some countries, implicit debts can amount to 50% of GDP, possibly 100% or even more.[3] The order of magnitude must be kept in mind when ringing the alarm bell about the recent debt build-up.

The overall situation can be less bad when assets are factored in, but it can be much worse when implicit liabilities are taken into account. The fact that these items cannot be computed with sufficient precision to be looked at with confidence does not mean that the issue can be ignored, as it is in most current discussions.

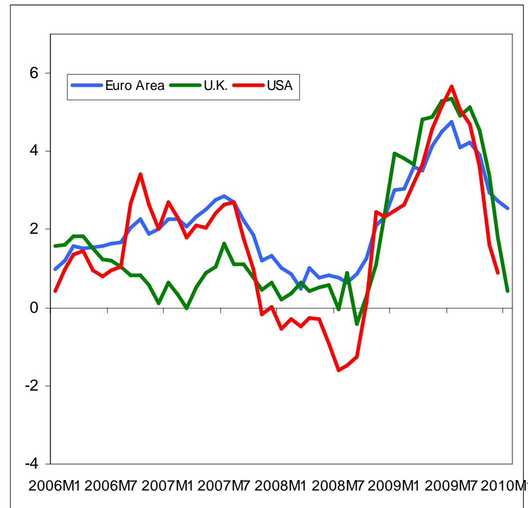
2. IMPLICATIONS FOR INTEREST AND EXCHANGE RATES

2.1. Impact on interest rates

The textbook presumption is that large debts lead to higher interest rate. The reasoning is straightforward: as increased public borrowing competes with private borrowing for scarce saving, the cost of borrowing must go up. The experience of the last two years does not confirm this presumption. As Figure 1 shows, real interest rates increased sharply at the time of the Lehman Brothers collapse as governments and central banks scrambled to rescue the financial system, but they declined when deficits started to deepen.

Figure 2. Real long-term rates

[3] See for example: Wyplosz, Charles, "Large and Unknown Implicit Liabilities: Policy Implications for the Eurozone", in: P. Wiertz, S. Deroose, E. Flores and A. Turrini (eds), *Fiscal Policy Surveillance in Europe*, Palgrave Macmillan, 2006.



Source: IMF

Truth is that the evidence on the impact of deficits and debts on the interest rate is sketchy, for good reasons. First, the advanced countries are integrated in the large global financial system and most of them are small. With the exception of the US, national deficits are 'small" in the big world of international finance and unlikely to shake global interest rates. On the other hand, interest rates on debts can include a risk premium, which is a very different argument, to which I return below. Second, this reasoning assumes that all else remains unchanged. At a time of worldwide upheaval, which prompted the budget deficits, many things are changing. The long list includes a flight to quality and to the (relative, maybe) security of public debts, a surge in saving as firms and households became alarmed and sometimes hurt by sharply reduced asset prices, and active reduction of short-term interest rates by central banks around the world.

While the "scarcity of saving" hypothesis is a weak reed to rely upon, the evolution of risk premia is better established but also puzzling. In principle, the risk premium measures the loss associated to a default. Higher debts can be seen as raising the odds of a default. Yet, the evolution of risk premia within the euro area is puzzling. Close to zero for years, even though some debts were high, the premia on the Greek, Portuguese and Spanish public debts have brutally increased in the midst of the crisis. Notwithstanding *ex post* interpretations from markets (concern with deficits and debt size), these changes reflect more superficial panic reactions than professional assessments. We are in presence of a self-fulfilling phenomenon, already observed during the Latin American and South East Asian crises.

2.2. Impact on exchange rates

The link between budget deficits and exchange rates is even more tenuous than with interest rates. The only firm link is in crisis times, when markets simultaneously run on a public debt and on the country's currency. Here again *ex post* justifications abound but preciously little can be said *ex ante*.

3. THE EUROPEAN IMMEDIATE RESPONSE

3.1. The Treaty: the letter and the spirit

The Euro Area has been brutally confronted with acute pressure on the Greek debt, along with threats of contagion to other countries like Portugal, Spain and Italy. When it appeared that Greece could be forced to default because financial markets would not refinance its maturing debt, a number of governments proposed a bailout. This came as major surprise since the so-far common understanding of the Treaty is that bailouts of member governments by other governments, European institutions and the ECB is strictly ruled out by Art. 123(1):

"Overdraft facilities or any other type of credit facility with the European Central Bank or with the central banks of the Member States (hereinafter referred to as 'national central banks') in favour of Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States shall be prohibited, as shall the purchase directly from them by the European Central Bank or national central banks of debt instruments."

Ever since the launch of the monetary union, this stipulation has been called the no-bailout clause. It has been vastly discussed in the context of the Stability and Growth Pact, as explained in Section 3.2. Its logic is very strong and goes to the heart of Europe's singularity. Price stability requires an independent central bank, but that may not be enough. History has demonstrated again and again that inflation occurs when budget deficits run out of control. In Europe, in the absence of a federal arrangement, authority over budgetary matters remains at the national level. There is no mechanism, therefore, to maintain fiscal discipline. Clearly aware of this, the Treaty has therefore sought to alleviate the problem in two ways. First, the no-bailout clause seeks to circumscribe budgetary issues – including runaway deficits – at the national level, since this is where the authority exclusively lies. Second, the Treaty envisions the Excessive Deficit Procedure, later enshrined in the Stability and Growth Pact, as a way of preventing and discouraging fiscal indiscipline.

There is no doubt that the concern about fiscal stability is justified and that the no-bailout clause is critically important to the price stability objective, which is itself the fundamental premise of the monetary union. This is the spirit of the Treaty.

The Greek debt crisis is the first time that the no-bailout clause becomes binding. At the time of writing this Note, the media report that some governments look for ways to still provide support to the Greek government. Apparently, this will rest on Art. 122(2):

"Where a Member State is in difficulties or is seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences beyond its control, the Council, on a proposal from the Commission, may grant, under certain conditions, Union financial assistance to the Member State concerned."

Interestingly, this article comes before the no-bailout clause, which suggests that it refers to something else, like natural disasters or imposed hostilities. The issue of bailout comes next. The letter is in line with the spirit, but indications suggest that it is planned to consider that the debt situation is "exceptional occurrences beyond [the] control" of the Greek government. An alternative is to channel assistance through private banks. Either way, this goes against the spirit of the Treaty.

3.2. The economics of bailouts and defaults

If it happens, the bailout will send a powerful message to governments and markets. To governments, the message will be that fiscal discipline is not strictly a national responsibility. To reduce the moral hazard thus created, governments and the Commission intend to impose tight conditions on Greece. This is highly problematic. The Greek budget is Greece's sole responsibility. Economic pressure can be exercised via the Stability Pact, but the threat of a fine of up to 0.5% of GDP is unlikely to make a strong impression on a government whose deficit could be as high as 13%. The EU has simply no instrument to impose conditions on a member government, especially as a *quid pro quo* for a potentially illegal support. In addition, reducing the deficit by 4% of GDP every year, as seems to be required from Greece, is bound to have a powerful contractionary effect. The requirement runs against the principle, argued in Section 1.2, that the effort should be spread evenly over many years. Greece will not be able to fulfil what is demanded of her. What happens next and what conclusions are drawn? Section 4.4 deals with these questions.

One alternative to the bailout is to accept that the Greek government defaults. Government defaults have been extremely rare in Europe but not uncommon elsewhere over the last decades. It is not an extraordinary event, nor a particularly traumatic one if well handled. Should Greece be forced to default, it would occur when the governments tries to borrow to pay back its maturing debt. If markets refuse to lend, Greece would be unable to pay back its debt, part of which is held by those who refuse to renew their loans. As always, Greece would have to sit down with its creditors and work out a deal: how much to pay back on due debt – the so-called haircuts – and when? Lenders always fight haircuts but are willing to negotiate a new repayment schedule, sometimes with some moderate penalty. That means a few months, possibly more, of uncertainty, during which Greece could not borrow on financial markets. It would probably check whether some of its citizens are willing to keep lending. If no fresh money is forthcoming, the Greek budget would have to be balanced. This is exactly what everybody wants the Greek government to do.

For the rest of Europe, this would be a non-event. Unless, of course, contagion were to spread to other countries. A few more governments would default, more non-events. At worst, the euro would depreciate. This would greatly help at a time when the economic recovery seems to be anaemic.

There is a simple way to avoid both the bailout and the default: borrowing from the IMF. It was created to lend to governments that cannot borrow on financial markets. The Pittsburgh G20 Summit increased in 2009 the IMF resources precisely to deal with the aftermath of the crisis. Germany, France, and the other G20 countries then thought that the IMF is ideally suited to the task. The Summit's communiqué said it all:
"The IMF should continue to strengthen its capacity to help its members cope with financial volatility, reducing the economic disruption from sudden swings in capital flows and the perceived need for excessive reserve accumulation. As recovery takes hold, we will work together to strengthen the Fund's ability to provide even-handed, candid and independent surveillance of the risks facing the global economy and the international financial system. We ask the IMF to support our effort under the Framework for Strong, Sustainable and Balanced Growth through its surveillance of our countries' policy frameworks and their collective implications for financial stability and the level and pattern of global growth."

4. LONGER TERM RESPONSES

When the dust settles, the time will come to draw the lessons from this crisis and improve the operations of the monetary union. The considerable amount of confusion that prevails in dealing with short-term pressure is likely to also lead to mistaken long-term solutions. A few simple observations could clear much confusion.

4.1. Limits of the monetary union

The unique characteristic of the European monetary union is that the common currency is shared by independent countries, each with its own budget. This is what makes the euro area different from other currency areas. As noted above, one implication is that fiscal discipline is delegated to sovereign states. The limits imposed by this feature have been recognised from the outset, of course.

In particular, the Founding Fathers of the Maastricht Treaty relied on three explicit disciplining devices: 1) the no bailout clause; 2) market-imposed discipline; and 3) the Stability and Growth Pact. The two latter work highly imperfectly, the former is in grave danger and, should it be tinkered with, the whole construction would unravel.

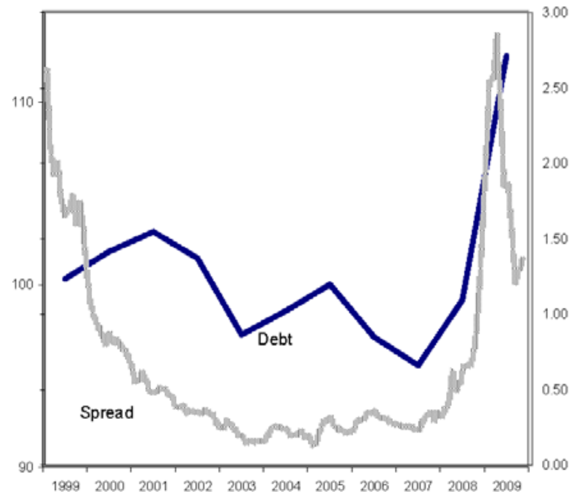
The first lesson is that we need to recognize that national sovereignty over budgetary matters is in the hand of national governments and parliaments, and will stay there for the foreseeable future.

4.2. Limits of market-led discipline

It was very clearly expected that financial markets would distinguish among public debts and impose a risk premium on the largest ones. This would operate as a clear signal on national governments and convince those that lack discipline to tighten up. As illustrated in Figure 3 for the emblematic case of Greece (which joined the Euro area in January 2001), this is not what happened. Until 2008, the spreads on countries with large debts and/or large deficits remained very small, usually around or below 20 basis points. Markets seem to not discriminate public debts one from another. Alternatively, they considered that the risk of default was very low.

Once the crisis started, the risk premium rose fast and far, as did the debt for reasons previously explained. Once again, we see that financial markets – and rating agencies – move too late and probably too much. Market-led discipline does not work as expected. This is the second lesson.

Figure 3. Greece: Interest rate spread and debt level



Sources: Interest rate spread: IMF. Debt: OECD
Notes: Spread over German bonds (right scale, %), debt to GDP ration (left scale, %)

4.3. Limits of the Stability and Growth Pact

As I have repeatedly emphasised in previous briefing notes to the ECON Committee, the Stability and Growth Pact is deeply flawed. Its flaws were clear from the outset. This negative judgment has been repeatedly confirmed. In 2002, a warning was issued to Ireland even though its public debt was quickly declining. In 2003, the Pact was suspended before France and Germany were to be issued warnings. The 2005 adjustment was largely cosmetic. In the following years, the Pact did not convince many governments to lower their debts even though sustained economic growth provided large revenues. As a consequence, when the crisis hit, these governments had limited room for manoeuvre within the Pact limits.

Critics of the Pact – including the present author – have argued that, as long as budgetary authority remains in national hands, there is little that can be done to influence governments whose main political incentives are domestic. It was also argued that the annual deficit is the wrong indicator because it is strongly influenced by business cycles. The correct criterion should be the medium-term evolution of the public debt, but the Pact aimed at the current debt level, with a criterion (60% of GDP) that has become increasingly unrealistic and, anyway, was too arbitrary to be enforced.

The third lesson is that attempts at superficially fixing the Pact are bound to fail.

4.4. Solution principles

There is no doubt that the question of fiscal discipline is the weak element in the current setup of the European monetary union. The Greek debt crisis provides a clear proof that a correction is needed. We now have a chance to plug this hole, but current debates suggest that this opportunity could well be missed. The risk is that Greece will be bailed out, that the conditions for the bailout will not be respected and that the tendency will be to make it even more constraining. This would ignore the lessons from this, and previous failures.

Instead, the following principles, which follow from the previous analysis, should guide the much needed reform:

1. There is a collective need for fiscal discipline to be enforced in every member country.
2. There is no collective responsibility for a country's lack of discipline.
3. Fiscal discipline can only be imposed at the national level.
4. The solution must be formal commitments by each country to adopt fail-safe institutions that deliver fiscal discipline.

Indeed, experience and theory show that fiscal discipline can only be durably maintained when the budgetary institutions are designed to that effect. Different countries have adopted different institutions. For example, in the Netherlands, budget numbers are certified by the Planning Bureau. In Germany, approximate budget balance is a constitutional requirement since June 2009 (to be phased in gradually). It is likely that different arrangements best fit different countries but the solution should be that each Euro area member commits to adopt an arrangement to be validated by the Commission. In this way, budgetary sovereignty can be preserved while the collective need for fiscal discipline is satisfied.