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POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICIES

ECONOMIC AND MONETARY AFFAIRS

Policy Implications of Increasing Debt and Deficits

NOTE

Abstract

The financial and economic crisis should not be seen solely as a problem but also as an opportunity to reform the Stability and Growth Pact (SGP) in a non-conventional way: through jurisprudence. By instituting a very short-term financing facility as an emergency measure, the European Council of Finance Ministers (Ecofin) will give *de facto* responsibility for imposing the conditions on Greece to the European Commission. This 'ties the hands' of the Ecofin and thus makes the imposition of structural reforms more credible since it puts unambiguous limits on Member States' increasing debt and deficits. Furthermore, this process works much faster than creating new legislation in the conventional way and implicitly leads to more political integration. In the end, it shows that the EU needed this crisis to enforce structural reforms, and by limiting Member States' fiscal policy, moves towards further political integration, albeit not via the front door but through the back door. Europe has always progressed that way.

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AUTHOR

Prof. Dr. Sylvester C.W. Eijffinger, CentER and EBC, Tilburg University and CEPR

RESPONSIBLE ADMINISTRATOR

Mr. Arttu Makipaa
Policy Department Economic and Scientific Policies
European Parliament
B-1047 Brussels
E-mail: arttu.makipaa@europarl.europa.eu

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ABOUT THE EDITOR

To contact the Policy Department or to subscribe to its monthly newsletter please write to: poldep-esc@europarl.europa.eu

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DISCLAIMER

1. Introduction[1]

The financial and economic crisis has created considerable concerns about the state of public finances of virtually all Member States as expensive measures have had to be taken to counter the downturn with detrimental impacts on public finances all over the European Union (EU). With 20 EU Member States (and 13 out of 16 Member States of the euro-zone) being subject to an Excessive Deficit Procedure (EDP), the credibility of its implementation is at stake.[2] In its quarterly report on the euro-zone of December 2009, the European Commission states that "… *crisis-related fiscal expansion and the ageing population raise questions about the sustainability of public finances in the euro-zone as well as in the rest of the EU.*" and expects that "… *government debts of many countries in the euro area will experience significant increases* …", while "… *soaring government bond issuance will put upward pressure on rates as the economies emerge from crisis and crowd out investment.*" President Jean-Claude Trichet of the European Central Bank (ECB) said in the Monetary Dialogue of December 2009 that: "… *many euro area governments are faced with high and sharply rising fiscal imbalances, which are not sustainable over the longer term. This could weaken public confidence in the sustainability of public finances, with adverse effects on market sentiment, leading to less favourable medium- and long term interest rates. Unsustainable fiscal positions may also complicate the task of our monetary policy to maintain price stability.*" Furthermore, the "asymmetry" of public finances in the euro-zone could also be a reason for concern. Since mid-2008, spreads for the Greek and Irish government bonds (compared to Germany) rose excessively. They were of the order of 300 basis points (bps) at their maximum and are still substantial. Many other Member States have had to pay about 100 bps on the German benchmark. The potential threat in such developments is that if the divergences go too far, this could be serious danger for the coherence of the euro, in particular if economic recovery led the ECB to raise interest rates, which would affect countries with high public debt even more. However, as the then Commissioner for Economic and Financial Affairs Almunia stated in January 2009: "… *the increase in spreads, if it is under control, can have positive effects such as market discipline*".

After assessing the problem of these divergences in Section 2, we will address the consequences of these divergences (as a result of the crisis) for the public finances in the EU and euro-zone in Section 3. These consequences can be enormous if member states do not adjust their fiscal balances and consolidate the budget. This brings us to the question of whether the procedures foreseen in the Stability and Growth Pact are sufficient to ensure that Member States will return to fiscal discipline. We will discuss in particular the reality [*unclear*] of a strict implementation of its corrective arm by introducing more enforcement in Section 4. Finally, in Section 5 we conclude.

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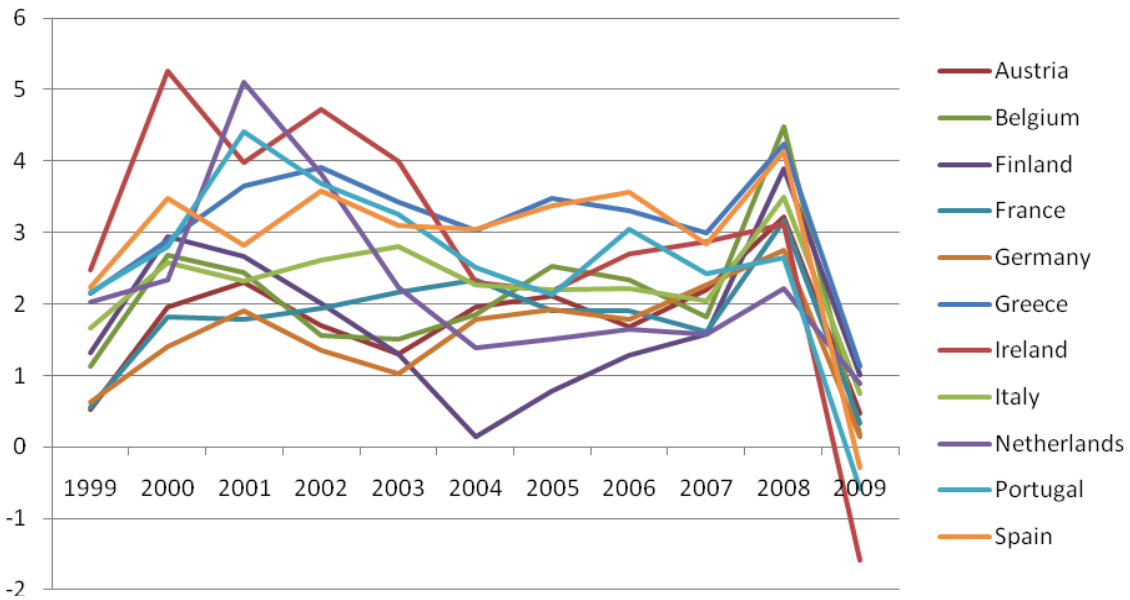
[1] The author gratefully acknowledges the very helpful comments of Mr. Edin Mujagic, MSc and the excellent research assistance of Mr. Rob Nijskens, MSc.

[2] Otmar Issing, former Chief Economist of the European Central Bank, said in *The Financial Times* in 2005 that perhaps only five of the original 11 (later 12) euro-zone economies were sufficiently converged for the monetary union to work. It went ahead anyway, for political reasons, on the assumption that convergence between the euro-zone countries would follow.

2. Divergences within the EU and euro-zone

The introduction of the euro in 1999, it was claimed, would narrow the economic differences between the member countries of the monetary union. Unemployment rates would converge, as would other important macroeconomic variables, such as unit labor costs, productivity, and fiscal deficits and government debt. Ultimately, the differences in wealth, measured in terms of income per capita, would diminish as well. This was also hoped for, as from the outset it was clear that a monetary union without a political union or at least something resembling a political union in Europe would find it difficult to survive in the long term. After the common currency's first decade, however, increased divergence has become the norm within the euro-zone, and tensions can be expected to increase[3]. The differences between Member States were already large a decade ago. The euro became the common currency of wealthy countries, such as Germany, the Netherlands and Finland, and much poorer countries, such as Italy, Greece and Portugal. Such differences were a highly complicating factor for the newly established ECB, which had to determine the appropriate interest rate for all members (the so-called 'one size fits all' policy). The larger the differences have become during the euro's first decade, the more the ECB's policy could be described as 'one size fits none'. Some IMF researchers have that applying the Taylor rule to individual euro-zone countries would have implied very different interest rates[4]. To illustrate the increasing divergence, we compare the performance of the first wave of euro-zone countries between 1999 and 2009. We compare the data for the 10 countries that were included in the first wave in 1999 (excluding Luxembourg), supplemented by Greece, which joined shortly thereafter.

Figure 1: Annual inflation, 1999-2009



Source: IMF World Economic Outlook, October 2009

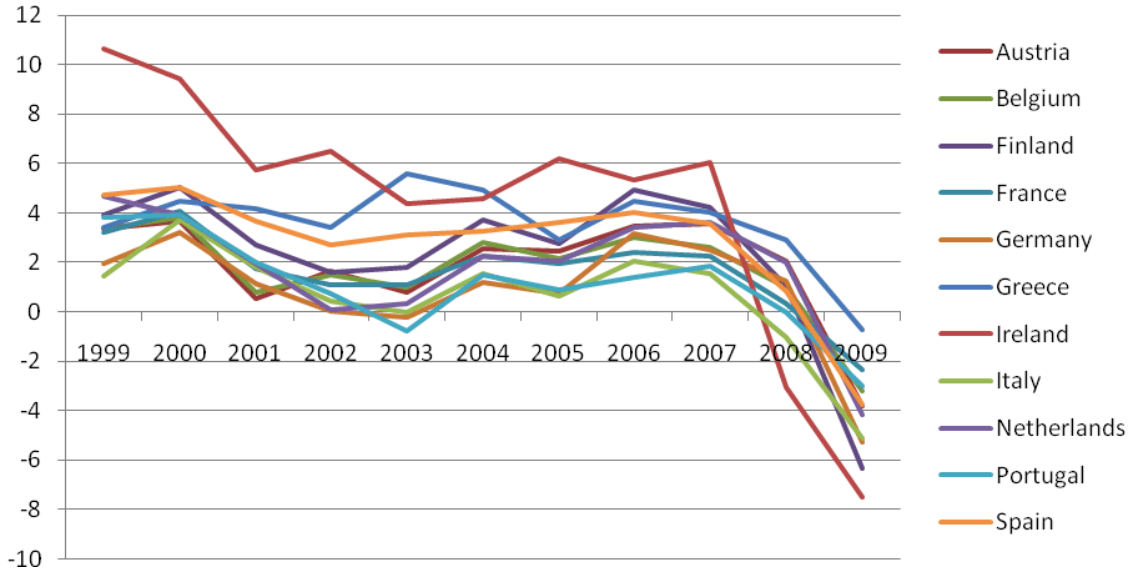
[3] Eijffinger, Sylvester and Edin Mujagic (2010), "The Euro's Final Countdown?", *Project Syndicate*, 08-02-2010

[4] Ahrend, Rudiger, Boris Cournède and Robert Price (2008), "Monetary Policy, Market Excesses and Financial Turmoil", *OECD Economics Department Working Papers*, No. 597.

Because the ECB was given the sole task of achieving and maintaining price stability in the euro area, inflation rates seem the most logical starting point for comparison. In 1999, the difference between the euro-zone countries with the lowest and highest inflation rate was around two percentage points (see Figure 1). By the end of 2009, the difference has fluctuated greatly, and become larger.

As for economic growth, we can see in Figure 2 that differences were reasonable to begin with, but that they have increased over the last decade. Moreover, the productivity difference between the slowest and fastest growing countries on average (Ireland and Portugal) increased from 25 index points in 1999 to 66.2 in 2008; the difference in unit labor costs went from 5.4 percentage points to 31.8; and the difference in the unemployment rate rose from 10.1 percentage points to 15.4[5].

Figure 2: Yearly GDP growth in percent



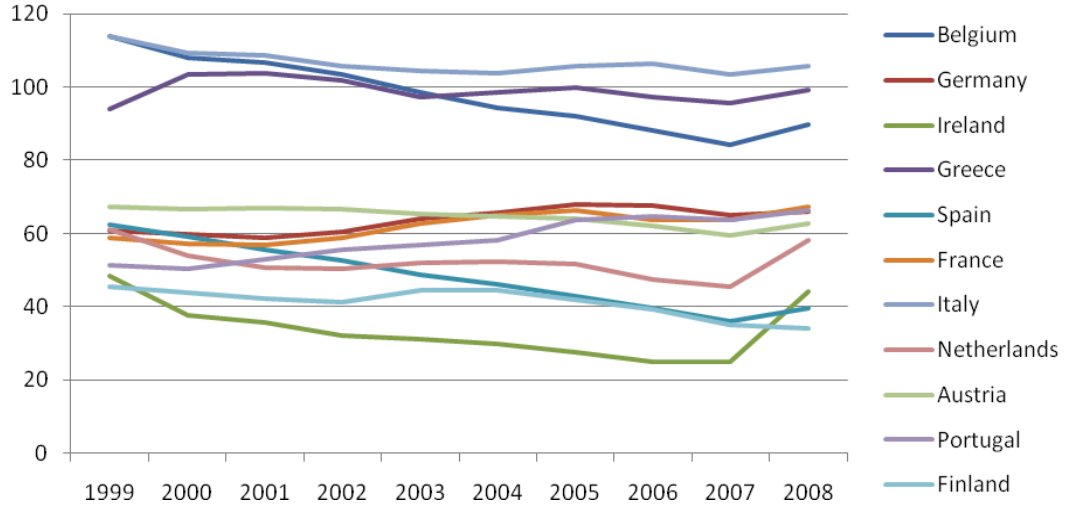
Source: IMF World Economic Outlook, October 2009

Nor could we find any convergence regarding government deficits and debt. In 1999, Finland boasted the smallest government debt, equal to 45.5% of GDP. The difference with the largest debtor in the euro-zone, Italy, was 68.2 percentage points. Despite the most severe financial and economic crisis in almost a century, the Finnish national debt actually decreased by 2009, to 39.7%.

Italy, meanwhile, failed to use the significant windfall from the steep decline in long-term interest rates caused by the introduction of the euro and a decade of rapid economic growth to repair its debt position. Italy's debt barely budged and stayed well above 100% of GDP. As a result, the difference between the debt positions of Finland and Italy, the most prudent and most profligate euro-zone members, shot up to 71.7 percentage points in 2008 (see Figure 3).

[5] Based on data from Eurostat.

Figure 3: Government debt as a percentage of GDP



Source: Eurostat

The implications of these increasing differences could be severe. As the markets have already hinted, several countries within the euro-zone are already facing difficulties. Greece, (but also Portugal, Italy, Ireland and Spain) are struggling with low competitiveness due to years of above-average inflation and high growth of wages, low real interest rates and worsening internal and external balances[6].

As a result, increasing tensions between the euro-zone countries on economic policy are likely, as are rowing rifts within the ECB Governing Council in the coming years. The disagreement on the issue of buying covered bonds last year, when some ECB Executive Board Members used to media to vent their huge differences in opinion in this matter is a good example. More recently, during the press conference on March 4th 2010 President Jean-Claude Trichet, when he referred to the decision to start scaling back some of the emergency measures the ECB put in place to combat the crisis, he said the decision was taken 'with overwhelming consensus'. In the past, he often said a decision was taken 'unanimously'. It is a slight but perhaps telling difference. Tensions at the ECB and between the euro-zone countries do not bode well for the stability of the common currency, both externally vis-à-vis other currencies, and internally in terms of inflation. ECB will be scapegoated for that. If it keeps its interest rate too long for too low, countries like Germany and the Netherlands will protest. If it hikes the interest rate, the southern euro-zone countries will complain. In any case, support for the euro, already fragile, will erode further, weakening the common currency and fueling even greater tensions.

These concerns have already translated into persistently high sovereign risk spreads for the countries facing the worst problems[7], exacerbating the unsustainable financial position of these countries in the euro-zone. As we will see in the next section, this poses a serious threat to the sustainability of public finances in the euro-zone as a whole.

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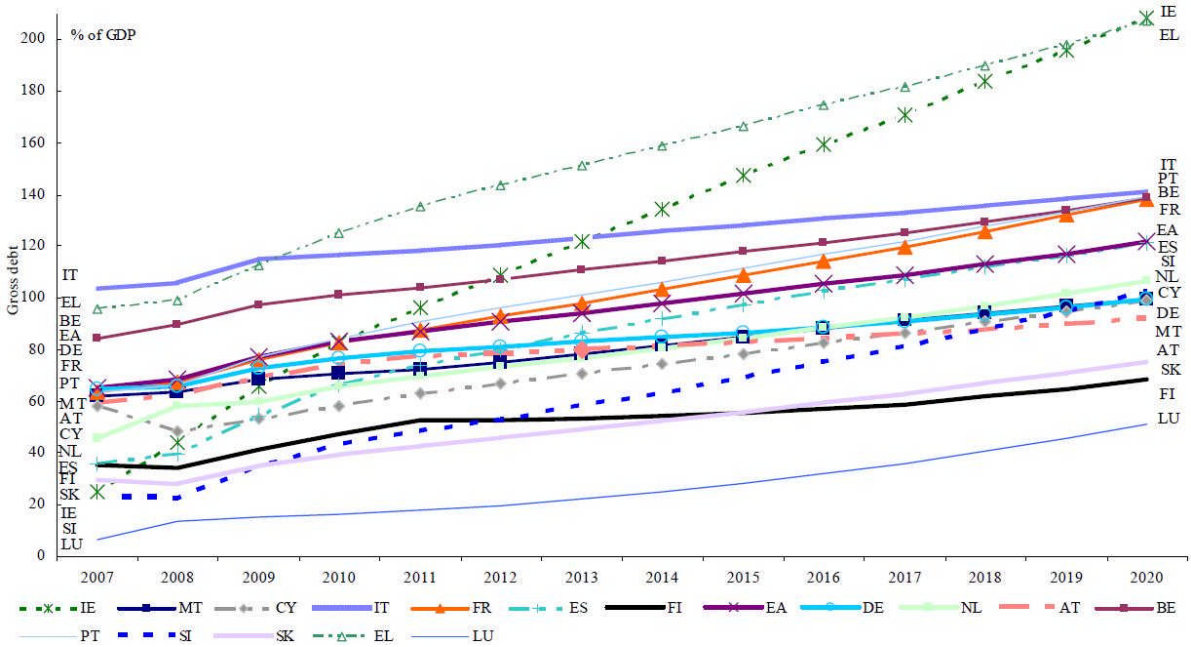
[6] Wolf, Martin, "The Eurozone's next decade will be tough", *The Financial Times*, 05-01-2010
[7] Sgherri, Silvia and Edda Zoli, 2009. "Euro Area Sovereign Risk During the Crisis," *IMF Working Papers*, 09/222, International Monetary Fund.

3. Sustainability of public finances within the EU and euro-zone

As mentioned in my Briefing Paper of January 2010 for the European Parliament's CRIS Committee[8], it is imperative for euro-zone governments to consolidate. This enhances sustainability of public finances, which is especially relevant when considering uncertainties about financial guarantees that may materialize in the near future. Not consolidating can become a severe problem for sustainability, as shown in Figure 4[9] and concluded by the European Commission in its 2009 report on the sustainability of public finances in EMU[10].

Figure 4: Forecast of government debt without consolidation



Source: European Commission (2009b)

Figure 5 then shows that, if countries manage to consolidate 0.5 percentage points of GDP per year during the coming decade, sustainability will improve on average. Note that this has to come on top of reverting the current fiscal stimulus measures, as advocated in Briefing Paper of January 2010 for the CRIS Committee. The European Commission also states that a consolidation of 1 percentage point per year may lead to a reduction in government debt during the next decade towards the 60% SGP level, as also shown in Figure 5. However, as shown in Figure 6 this will not be enough for countries such as Spain, Ireland and Greece, who need to exert a much larger budgetary effort to reach sustainable debt levels in 2020.

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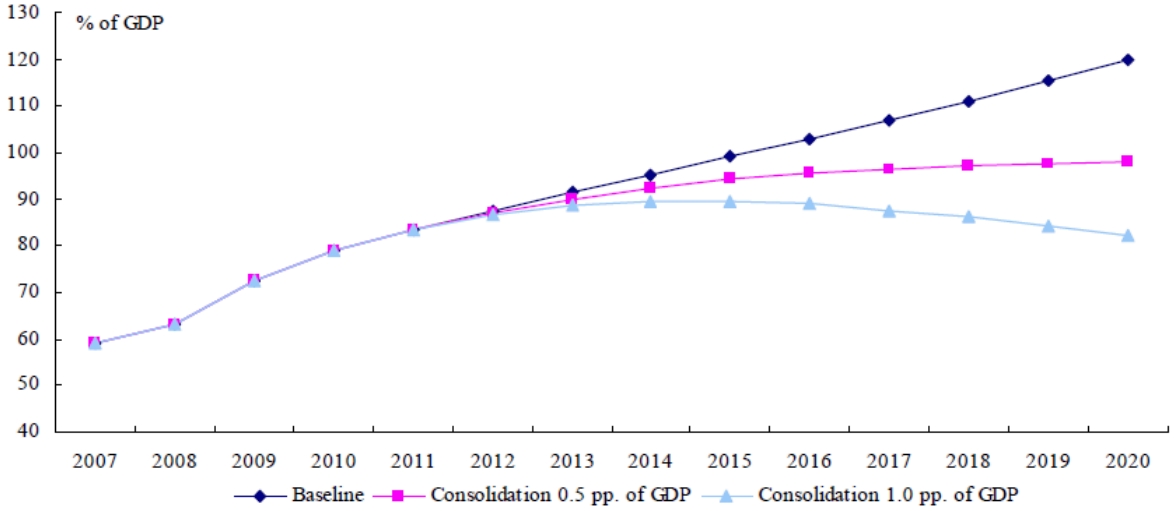
[8] Eijffinger, Sylvester (2010), "Spread of the Crisis – Impact on Public Finances", Briefing Paper for the CRIS Committee, January 2010.

[9] European Commission (2009b) "European Economic Forecast – Autumn", *European Economy*, 10, October, Brussels.

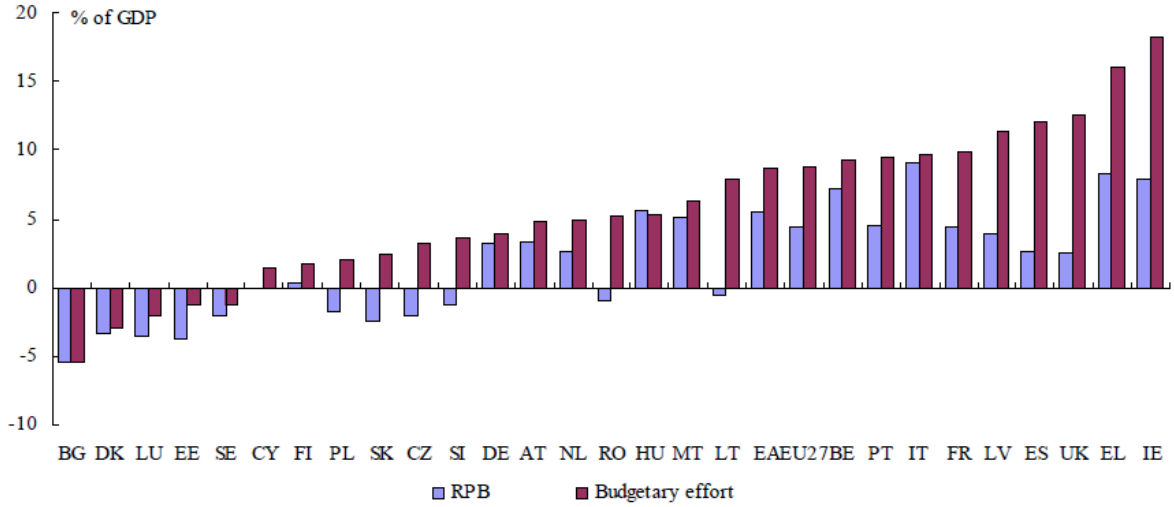
[10] European Commission (2009a), "Public finances in EMU", *European Economy*, 5, June, Brussels.

Figure 5: Forecast of government debt with consolidation



Source: European Commission (2009b)

Figure 6: Required budgetary effort to reach sustainability



Source: European Commission (2009b)

This will be an even larger problem when debt issuance becomes difficult, even though governments have become more flexible with issuance procedures. Although there are signs that issuance conditions are becoming tougher, most debt managers have been successful in financing the surge in funding needs (Greece is a notable exception). Thus far, there is no solid evidence of systemic market absorption problems. The future could become more challenging though given that rising issuance is occurring in tandem with increasing overall debt levels and debt service costs. Governments must therefore think about medium-term exit strategies or consolidation. As central banks determine the interest rates, they in turn should take the same issues into account when determining their exit strategy by tightening monetary policy.

However, while consolidation and financing possibilities are important, at the base of these problems lays the incomplete reform of the SGP and the accompanying EDP. In the next section, we will sketch the required reform of the Pact to solve and avoid the fiscal imbalance problems in the EU and euro-zone.

4. The enforcement of the Stability and Growth Pact

Although the SGP has undergone a thorough reform in 2005, this reform was mainly about increasing the flexibility of the pact. As argued by Buti et al. (2005)[11], the reform should also extend to better enforcement of the pact by reforming the Excessive Deficit Procedure. Specifically, there should be clearer resolution mechanisms for dealing with violation of the SGP rules.
A very good example for strengthening of the enforcement mechanism can be the Basel-Nyborg accord in the context of the European Exchange Rate Mechanism (ERM). This accord was an innovation in dealing with speculative attacks on currencies as it enhanced the credibility of the no-bailout clause in the ERM by introducing the *very short-term financing facility*. This facility allows countries to intervene when their exchange rate risks breaking the bandwidth margins of the ERM, albeit under very strict conditions. It is explicitly stated that this does not constitute a bail-out, and by imposing strict conditions this facility is a credible mechanism to deter speculators. Although the problems in the euro-zone manifest in speculative attacks on interest rates [*I don't understand this,what does he mean by speculative attack on interest rates?*], this is only a direct consequence of having a monetary union. Reform of the EDP can thus be designed along the same lines as the ERM very short-term financing facility, coupled with very strict conditions on fiscal consolidation to return to fiscal sustainability. Greece should be the test case for this new mechanism of very short-term conditional assistance coupled with enhanced monitoring. The very short-term financing facility should be extended with a maturity of less than three months, with possible renewal if Greece meets the (further) conditions. The country should not only use this assistance to consolidate the budget, but also to carry out institutional reforms that are otherwise hard to implement politically. This mechanism is thus not only a way to protect against speculative attacks on sovereign debt, as the Basel-Nyborg innovation, but also a way to make governments commit to structural reforms and fiscal consolidation. Note that this is a solution already advocated e.g. by Barry Eichengreen[12], George Soros[13] and Nouriel Roubini[14].

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[11] Buti, Marco, Sylvester Eijffinger and Daniele Franco (2005). "The Stability Pact Pains: A Forward-Looking Assessment of the Reform Debate". *CEPR Discussion Paper*, No. 5216, CEPR, London.
[12] Eichengreen, Barry (2010), "Europe's Trojan Horse", *Project Syndicate*, 15-02-2010.
[13] Soros, George (2010), "The Greek Conundrum", *Project Syndicate*, 23-02-2010.
[14] Roubini, Nouriel (2010), "Teaching PIIGS to fly", *Project Syndicate*, 15-02-2010.

5. Conclusions

The financial and economic crisis should not be seen solely as a problem but also as an opportunity to reform the SGP in a non-conventional way: through jurisprudence. By instituting a very short-term financing facility as an emergency measure, the Ecofin will give *de facto* responsibility for imposing the conditions on Greece to the European Commission. This 'ties the hands' of the Ecofin and thus makes the imposition of structural reforms more credible since it puts unambiguous limits on Member States' increasing debt and deficits. Furthermore, this process works much faster than creating new legislation in the conventional way and implicitly leads to more political integration. In the end, it shows that the EU needed this crisis to enforce structural reforms, and by limiting Member States' fiscal policy, moves towards further political integration albeit not via the front door but through the back door. Europe has always progressed that way.

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