Notes on the Euro Debt Crisis [1]

Jordi Galí

CREI, UPF and Barcelona GSE

June 2010

[1] Correspondence: Ramon Trias Fargas 25; 08005 Barcelona, Spain. Prepared for the Bernácer Conference on "The Euro after the Greek Crisis" held at the Bank of Spain on June 2, 2010. I thank conference participants for useful comments.

1. Introduction

As documented by Reinhart and Rogoff (2010), financial crises have often preceded sovereign debt crises, where the latter are defined as episodes involving either the restructuring of government debt or outright default. It is still too early to tell whether the recent global financial crisis may end up being an exception to that historical pattern, but developments over the past few weeks are not conducive to much optimism, with several euro area countries --including Greece, Portugal and Spain-- seeing the sustainability of their public finances called into question.

The recent developments have also brought back center stage the debate about the appropriate fiscal framework for the euro area, with many questions being raised about the suitability of existing arrangements, beyond the specific policy response to the current crisis. Perhaps more worrisomely, many political leaders and commentators seem to have established a link between the current debt crisis and the future of the euro and, more generally, of European integration.

In the present note I review some of the recent developments and argue that the attempts to link the debt crisis with the euro are misleading and dangerous. In particular, the survival of the monetary union should be independent of the fiscal behavior of its members. With the right rules in place and enforced, the fiscal rectitude of all euro area members (as desirable as it may be on other grounds) should not be viewed as a necessary condition for the proper functioning of the monetary union. On the other hand, a fiscal framework (like the current one) that imposes tight limits on the debts and deficits of euro area countries is likely to remain a source of perpetual tensions and conflicts. In my view, the latter represent a bigger danger for the future of the euro than fiscal laxity or default by any given member state.

2. The Current Fiscal Framework of the Euro Area

The fiscal framework of the euro area rests on the principle of decentralization and autonomy of budgetary and fiscal policies, which remain an exclusive competence of the member states. Those policies are, however subject to some discipline rules, defined by the Treaty and the Stability and Growth Pact (SGP):

- *No bailout*. Neither the EU nor any member state shall be liable for the debts of central, regional or local governments or any other public bodies of any member state (Article 125 of the Treaty)
- *No monetization of government debt*. Neither the ECB nor the national central banks can extend credit to or purchase debt directly from governments or public institutions of member states (Article 123 of the Treaty)
- *Avoidance of excessive government debts and deficits*. Compliance with that principle is to be monitored on the basis of two indicators, the deficit/GDP and debt/GDP ratios (actual and projected), and their relation to their reference values (3% and 60%). Furthermore, member states should aim at medium-term budgetary positions close to balance or in surplus. This should give sufficient room for the operation of automatic stabilizers without overshooting the 3% budget limit. Unless deemed temporary or due to exceptional circumstances, violations of those rules should trigger an “excessive deficit procedure”, which could lead to eventual sanctions in the absence of timely correction measures.

Until the recent debt crisis episode the first two principles above had been upheld, but the same cannot be said about the third one. In particular, several countries were allowed into the euro area while holding debt ratios well above the reference value (e.g. Greece, Italy, and Belgium). Furthermore, the implementation of the excessive deficit procedure has been

applied unevenly, with some countries (e.g. France and Germany) avoiding having their deficit declared excessive despite having overshot the established limits. The reform of the SGP in 2005 led to a further relaxation of the conditions for triggering the excessive deficit procedure. As late as 2007, and before the economic downturn started to affect all countries' public finances, three euro area members (Greece, Italy, and Belgium) were still maintaining debt ratios above or close to 100 percent.

3. From the Global Financial Crisis to the Euro Debt Crisis

The global financial crisis that began in 2007 led to a huge deterioration in the public finances of most industrialized countries, with members of the euro area being no exception. Three main factors account for that deterioration:

- The workings of automatic stabilizers, with some sources of revenues declining rapidly with income and activity, and some spending components rising automatically (e.g. unemployment benefits).
- The non-negligible discretionary countercyclical policies put into place by many governments to limit the size of the contraction.
- The sudden growth in "hidden" public liabilities associated with an eventual rescue of the financial sector.

As a result of these developments, the government deficits of most euro area countries have clearly overshot the 3% limit set by the SGP. The size of those deficits, combined with their persistence (due to the unusual length of the recession and the slow projected recovery), has led to a rapid increase in the projected debt-GDP ratios. In some countries, most notably Greece, the difficulties have been compounded by the confluence of a number of factors, including:

- A large initial debt-GDP ratio
- A weak financial sector
- Government manipulation of budget statistics
- Lack of credibility of the announced fiscal adjustment programs, due to the perceived difficulties in their implementation and/or overoptimistic forecasts.

Investors' assessment of the sustainability of public finances of several euro area countries worsened over time, to a greater or lesser extent depending on each country's circumstances and specific developments. This has been reflected in the rise in several countries' bond yields relative to that of German debt of similar maturity. The large and rising spreads signal the serious difficulties experienced by those countries in financing their large current deficits, and in refinancing the maturing debt. They also threaten to trigger some perverse fiscal dynamics, whereby high deficits and debt levels lead to high costs of debt refinancing, which in turn lead to a further increase in deficit and debt levels, thus raising the specter of an eventual default. The latter would presumably take the form of a debt restructuring (possibly with bondholders taking a haircut) or, in the extreme scenario of a country's withdrawal from the euro area, as a likely re-denomination of the outstanding debt into a (devalued) national currency.

The possibility of an imminent funding crisis in Greece, which could have led to a debt restructuring or default, was the main motivation behind the two successive rescue packages (of 110bn and 750bn euros, respectively) put together in extremis by the euro area countries and the IMF, in close coordination with the ECB. The core element in the final package was a "European Stabilization Fund" of 440bn euros to purchase government debt from countries facing funding difficulties, at an interest rate below the market one. In order to finance its purchases, the fund would issue debt guaranteed by member states. The activation of this fund, as well that of parallel IMF financing would be conditional on the approval of a strict

budget adjustment plan to be adhered to by the beneficiary country, and which should guarantee its ability to meet its financial obligations in full.

4. The Need for a Reassessment of the Fiscal Framework

The fiscal developments of the past two years, culminating with the rescue package put together in extremis on the weekend of May 9, represent a "failure on a grand scale" of the current fiscal framework of the euro area. Two factors warrant that negative assessment.

Firstly, it seems clear that the terms of the agreed rescue package violate the Treaty's "no bailout" clause, to the extent that euro area taxpayers are (indirectly) assuming the risk of a sovereign default by the member state whose debt has been purchased by the stabilization fund. Furthermore, the ECB decision to start purchasing government debt from countries facing funding difficulties seems to violate the "no monetization" rule, in spirit if not in the letter (since the purchases are not direct). The loss of credibility implied by those moves can hardly be overstated, and may even be partly irreversible.

Secondly, the preventive arm of the SGP has clearly proved useless: most governments failed to build a sufficiently large surplus in good times, one that would make room for the necessary fiscal loosening during the downturn, without the need to incur in double digit deficit ratios. As a result of the ensuing large and persistent deficits, it is clear that the 60% ceiling for the debt ratio will be violated by a large number of countries (and possibly by the euro area as a whole) for many years to come.

In my opinion, these considerations would warrant by themselves a thorough reassessment of the current fiscal framework of the euro area, independently of the eventual success or failure of the recent rescue package in stabilizing government debt markets and avoiding default. But the urgency of that reassessment is made even clearer by the political

strains generated by the recent debt crisis. If the euro area is to survive as a monetary union, a reoccurrence of the political drama and tensions experienced over the past few weeks is to be avoided at all costs.

As part of that reassessment, a majority of voices (or at least the louder ones) are calling for a "more of the same" approach, i.e. for a upholding the three principles behind the current framework, while tightening the constraints on deficits, and strengthening the sanctions for countries that fail to abide by the rules. The sanctions that have been put on the table include the foregoing of EU funds, the loss of the right to vote in EU or euro area institutions and even the expulsion from the euro area. These sanctions go well beyond the fines foreseen (though never enforced) in the SGP.

A reassessment of the euro area along the previous lines, raises what I view as a serious concern: given that the enforcement of relatively weak rules and sanctions already proved so difficult in the past, it is not at all clear how the enforcement of stricter rules and tougher sanctions will be brought about. Thus, a stricter fiscal framework could in practice become a source of more frequent and possibly deeper political crises that would put the entire monetary union at risk.

Next I would like to put forward an alternative to the "more of the same" approach, one that would involve a substantial change of philosophy relative to the current fiscal framework. This is not meant to be a serious formal proposal, but instead a device to force myself (and hopefully the reader) to think about the rationale behind the principles and rules underlying the current euro area fiscal framework and, hence, the desirability or not of preserving those principles and rules. The proposed alternative framework rests on three premises, which I take to be true:

- The creation of a monetary union is a major achievement that needs to be preserved.

- Financially irresponsible governments happen (and will continue to happen).
- Political tensions arise when decisions are made that involve large transfers of resources among citizens of different countries. Such tensions among euro area members constitute a clear danger to the survival of the euro.

Is there a set of principles for the euro area fiscal framework that would be consistent with those premises? The next section lists a set of principles that, in my opinion, would meet such desiderata.

5. An Alternative Fiscal Framework for the Euro Area

An alternative fiscal framework for the euro area could rest on the following principles.

- No collective bailouts of member states should be allowed. Yet, there is no reason to ban voluntary bailouts by individual governments, either on ad-hoc basis or based on outstanding bilateral arrangements.
- The principle of no monetization of government debt by the ECB should also be preserved. Contrary to what has been often asserted in the press during the current crisis, the rationale behind this principle is unrelated to the potential inflationary consequences of such monetization, since purchases of government debt can always be sterilized in order to leave short-term money market rates unchanged. Its rationale rests instead on the risks implicitly assumed by euro area taxpayers, given the possibility of default of the government whose debt is purchased by the ECB and since, by definition, that risk is likely to be non-negligible whenever the ECB decides to undertake such purchases. [2]

[2] Government debt should still be acceptable as collateral for the credit extended to banks of member states as part of the regular ECB liquidity injection operations, as long as it satisfies some minimum

- Euro area governments facing a funding crisis (either of their own making or due to "irrational" contagion) should be allowed (and perhaps even encouraged) to request financial support from the IMF. There is no reason other than an unwarranted superiority complex to demonize an IMF intervention in the euro area, as has been done repeatedly during the current crisis. In particular, by standing ready to play its role as a lender of last resort the IMF can act as a permanent backstop to prevent unwarranted contagion. Furthermore, as an external agent, the IMF is likely to be more effective than any other arrangement that remains "within the club" at enforcing fiscal discipline and guaranteeing the strict conditionality of financial support.
- No formal constraints should be imposed on the debts or deficits of member countries. Instead, markets should be allowed to discipline governments (if they want to be disciplined), by forcing higher yields on their debt as a function of the perceived probability of default. Existing empirical evidence points to a significant (and possibly nonlinear) effect of indicators of fiscal imbalances or default risk on the spread of government debt from euro area countries relative to German bunds of comparable maturity (Manganelli and Wolswijk (2009), Gómez-Puig (2008)). See Figure 1, borrowed from Manganelli and Wolswijk (2009) for illustrative evidence.

requirement, and a sufficiently large haircut is taken over the market price (so that the implicit risk borne by taxpayers is nil for all practical purposes).

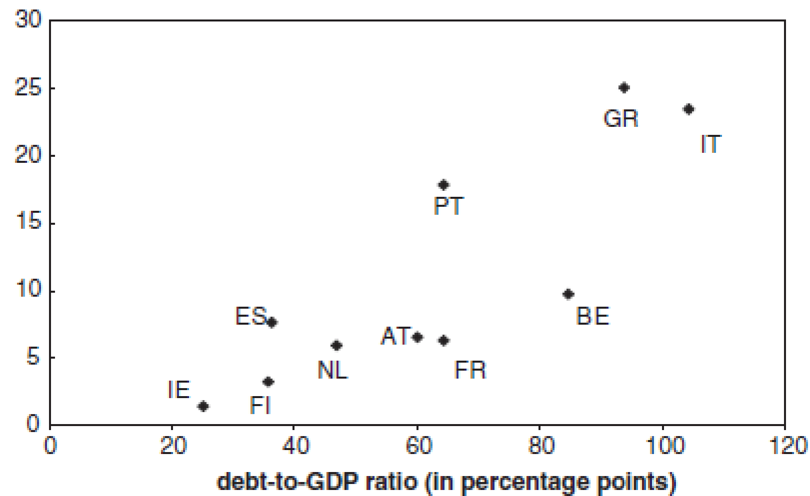

Figure 1: Interest rate spreads vs. Debt-GDP ratios 2007.

Source: Manganelli and Wolswijk (2009)

A similar phenomenon seems to apply to debt issued by U.S. states (Bayoumi, Goldstein, Woglom (1995)).

Two arguments are often invoked to dismiss the desirability of leaving exclusively to markets the job of disciplining governments. First, it is argued that market yields will not "fully" penalize heavy borrowers if a bailout cannot be ruled out. But that should be an additional reason to enforce strictly the "no collective bailout" rule, and also a good argument for any individual country to stay away from voluntary bailouts. Secondly, it is said that individual countries borrowing in integrated capital markets will fail to internalize the spillovers (operating through higher interest rates) from their actions. But while this argument is in principle correct, it should be clear that is not specific to countries that form a monetary union, it also applies to any country that participates in global capital markets.[3] Furthermore, if this were the main rationale for the constraints on debts and deficits, it would be unfair to impose the same fiscal thresholds to countries of different sizes, since any given deficit or debt

[3] Eichengreen and Wyplosz (1998) made that point in an article that can be viewed as nearly-prophetic.

ratio for a large country implies much larger spillovers on other countries that an analogous statistic corresponding to a smaller country.

- In my view, the most important element of any reassessment of the euro area fiscal framework consists in ending once and for all the taboo that a sovereign default (most likely in the form of a debt restructuring) is not acceptable in the euro area. Why can't a euro area country default, carry the weight of its decision, and let other countries move on with their business? There is no fundamental reason why such an event should trigger a crisis that could call into question the survival of the euro. In other words, "the Greek debt crisis should not be a crisis of the euro." By establishing that connection political leaders have turned a potential sovereign default into an excuse for triggering a negotiation involving a transfer of resources between taxpayers from different euro area countries, with the consequent (and unavoidable) political tensions.

  Of course, if banks or other financial institutions in the euro area hold large amounts of the suspicious government debt, some governments may feel compelled to jump to their rescue. But this is yet another argument for a tighter regulation of banks (including a limit on the size and quality of their government debt portfolios), and not so much for constraining the debts and deficits run by euro area governments. In addition it does not justify a collective intervention at the euro area level, since this is not the level at which the regulation failure has occurred.

The implementation of a fiscal framework along the previous lines may or may not reduce the probability of a sovereign default in the euro area in the foreseeable future. In my opinion, it would provide more solid foundations for the survival of the euro area as a monetary union, and of the benefits that the latter has brought to its citizens in the form of price stability, enhanced competition, and greater ease of transactions.

References

Bayoumi, Tamim, Morris Goldstein, and Geoffrey Woglom (1995): “Do Credit Markets Discipline Sovereign Borrowers? Evidence from U.S. States,” Journal of Money, Credit and Banking (27), no. 4, 1046-1059.

Eichengreen, Barry and Charles Wyplosz (1998): “The Stability Pact: More than a Minor Nuisance?,” *Economic Policy*, 67-104.

Gómez-Puig, Marta (2008): “Monetary Integration and the Cost of Borrowing,” *Journal of International Money and Finance* (27), 455-479.

Manganelli, Simone and Guido Wolswijk (2009): “What drives spreads in the euro area government bond market?,” *Economic Policy* (58), 191-240.

Reinhart, Carmen and Kenneth Rogoff (2010): “From Financial Crash to Debt Crisis,” NBER WP 15795.