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The Debt Crisis and the Treaty

NOTE

Abstract

The decisions taken by euro area governments on May 9 and by the ECB have radically transformed the monetary union. They are directly inspired by the Greek rescue plan. While this plan has (temporatily) suspended the crisis, its long-run consequences are drastic and dangerous. The currently discussed crisis resolution regime stands to reinforce this drift. A better approach would decentralize to the national level the responsibility of establishing and maintaining fiscal discipline.

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EXECUTIVE SUMMARY

1. The public debt crisis is the consequence of inadequate preparation and reaction in closed policy circles. The treatment of the crisis equally reflects the same lack of a broader perspective. The risk is that the next steps, designed to take stock of what happened, will rely on a misguided analysis, narrowly focused on immediate short-run measures, while long-run damage to the credibility of the euro will be ignored.

2. Short-run relief, long-run grief. The Greek bailout by other governments and by the ECB may have temporarily suspended speculative pressure, but at the cost of undermining very fundamental Treaty safeguards against fiscal indiscipline.

3. The proposed crisis resolution mechanism is not an improvement over IMF assistance. Conditionality is economically complex and politically delicate; it requires a staff with a strong experience and permanently engaged. The newly adopted European Financial Stability Fund, in charge of the largest EU budget, is likely to be a shadow fund with informal governance, designed to circumvent the no-bailout clause of the Treaty.

4. Fiscal policy is part of national sovereignty and yet price stability in the euro area requires that each government be fiscally disciplined. The solution to this apparent contradiction is to decentralize the responsibility for fiscal discipline from the European level to the national level.

5. Each euro area member should be requested to establish fiscal policy-making institutions that effectively guarantee fiscal discipline. There are many possible institutional arrangements and there is no reason for each country to adopt the same model, but each solution must be compatible with a new norm to be established.

1. WHAT IS THE PROBLEM?

Economic and financial crises never come from blue skies. The pressure builds slowly up but it often goes unnoticed except by some observers who are not listened to. When the crisis erupts, lack of adequate preparation creates a sense of emergency that discourages the search for the best response. Instead, the authorities settle for less, possibly for solutions that will turn out to be lethal again.

The subprime crisis is a good example. For several years, at least since 2005, housing prices in the US had embarked on a bubble path and lending by mortgage houses was increasing in quantity and decreasing in quality. The transformation of dangerous loans into AAA-rated complex assets went on for several years. (In Ireland and Spain too, housing prices and mortgage lending have been rising at unsustainable rates for several years.) The early temptation of the US authorities was to not rescue banks. When they was forced to, after the Lehman case showed what the stance entailed, the US authorities dithered considerably with the TARP programme.

The same applies to the Greek debt crisis. The budget has been in large deficit for several years. Interest rates on the Greek debt started to rise immediately after the Lehman collapse in September 2008. It took more than year for the situation to become critical. This happened a few weeks after the elections when markets, which had been waiting for a new government to be elected, decided that the situation was worrisome enough to turn to crisis. The trigger was the perception that the newly-elected authorities were not ready to take strong measures. The euro area governments then took a few erroneous decisions. By designing the Greek crisis a matter of common concern and by refusing to let Greece apply to the IMF for assistance, they created a link between the euro and the Greek debt that did not exist and they imposed upon themselves to provide support. They believed that a few billions would impress the markets. Eventually, the IMF was called to the rescue and the cost was multiplied by a factor of 10. Wrose, the Greek public debt crisis became the euro crisis, prompting contagion.

This observation, which is very general, carries many important implications. Three of them are worth emphasizing.

- First, in most if not all cases, crises could have been avoided if the authorities had recognized the looming danger and taken appropriate action sufficiently early on. There is usual ample time to do so.
- Second, “appropriate action” is one that directly addresses market concerns. It is understandable that, in quiet times, the authorities dismiss market concerns as unjustified. Indeed, market concerns often are often unjustified when based on reasonable assumptions. However, it is in the nature of many financial crises to be self-fulfilling. This means that market concerns can radically change the situation. For example, sharp increases on the Greek debt made it almost impossible for the authorities to keep rolling over the maturing debt, for fear of an acceleration of the debt build-up that would have been indeed explosive.
- Third, why don’t authorities act when it is time and relatively easy to quiet markets down? Denial, driven by political expediency, is often mentioned. An alternative is the deleterious effects of “group thinking”. Policy debates usually occur among a small number of like-minded persons. The media, given information by these persons reputed to “know better”, rarely dissent in a serious way. Outsiders either reinforce the conventional wisdom or dissent but then they are viewed as uninformed and their views are dismissed.

2. MISLEADING ANALYSIS BASED ON MISLEADING POLICIES

These observations also apply to current policy deliberations about reforms of the euro area. A new conventional wisdom emerges, entirely shaped by the policy actions of the last few months, which were focused on stopping the crisis but lost track of the monetary union's fundamental principles. While the Commission and most euro area governments seem intent on pursuing plans to strengthen the Stability and Growth Pact, there are good reasons to believe that the plan will not work and that the vserious damage that has been created is not attended to. Put differently, stopgap measures undermined the euro area and they need to be corrected, but current official thinking remains framed by these stopgap measures.

In my last briefing notes, I argued that:

- It is against the spirit, at least, of the Treaty to bailout governments that cannot meet their debt obligations (art.125). Member governments argue that this is not a bailout, that they are simply lending at market conditions. This is unconvincing. If Greece could borrow at the same conditions, it would not need official lending.
- The Stability and Growth Pact has not worked and cannot work because policies cannot be imposed on sovereign countries. The only strong influence of the Pact is via sanctions, but imposing sanctions is likely to be ineffective, or politically divisive, most likely both.

Since then, on May 9, the euro area governments have announced a €750 billion plan to provide guarantees to other public debts. The IMF share (€250 bn.) of this plan does not really exist; it is only an announcement that the Fund might mobilize resources if other euro area countries request assistance. The remaining €500 bn. represents a sort of European Monetary Fund, which is not economically needed since there already is an IMF. In addition, its governance is likely to be elusive, as argued in more details below.

Then, on May 10, the ECB has joined governments and announced what also amounts to a bailout. This, again, is against the spirit of the Treaty's interdiction for the ECB to directly finance budget deficits (art. 130) §and to monetize public debts (art. 123). Much against its constantly restated doctrine, the ECB has undertaken to buy *outright* public debts of euro area countries that are considered as risky by financial markets. Indeed, so far, the ECB had not bought public debt instruments; instead, it has been holding them in the form of repurchase agreements – in effect, loans – designed to avoid any risk taking. The difference is important since the ECB now stands to suffer losses in the event that some governments would default. As a consequence, the ECB has a stake in avoiding defaults. The fear is that it may be led to absorb vast – potentially unlimited – quantities of public debts, in effect monetizing the corresponding debt.

The practical implication of these decisions is that very fundamental Treaty safeguards against fiscal indiscipline have been undermined. Indeed, the purpose of the no-bailout clauses for governments (art.125) and the ECB (art.123 and 130) was to solemnly warn each euro area member country that, being sovereign in its decisions, it would have to take full responsibility for the consequences of violating fiscal discipline principles. A country that faced the wrath of financial markets would have to re-establish debt sustainability without help and without any possibility to devalue. In other words, the Treaty foresaw that fiscal discipline would eventually prevail because these provisions were intended to be credible *ex ante* and enforced *ex post*. In the midst of the crisis, the Treaty provisions have not enforced when the case arose. Their credibility has been undermined. This issue is further examined in Section 4.

The Treaty also included the Excessive Deficit Procedure, the legal basis for the Stability and Growth Pact. Ever since its adoption in 1997, the pact has been criticised as follows:

- The pact is economically ill-designed. Annual deficits are not related to fiscal discipline because annual deficits are subject to cyclical influence and are not therefore representative of the long-term orientation of fiscal policy that delivers, or not, debt sustainability. The 3% and 60% thresholds are arbitrary.
- The Treaty is legally in contradiction with national sovereignty.
- The Treaty's only "teeth" are sanctions that are politically dangerous.

Unsurprisingly, the Stability and Growth Pact has not delivered. It had to be suspended in 2003 for all three reasons above. It imposed procyclical fiscal policies in the midst of a serious economic slowdown. It was rejected by the two largest countries, France and Germany, which did not want to face the direct threat of sanctions.

The pact was modified in 2005. The reform aimed at some of the most glaring economic limitations of the first pact, which had been ignored for years, but it retained the idea of annual commitments and retained the increasingly incredible 3% and 60% thresholds. None of the other objections were addressed. Even partially repaired, the Pact did not prevent the situation that we now face as several countries failed to stabilize and roll back their public debts. The best that can be said about the pact is that the situation would be worse without it. That is arguably not good enough.

3. THE NEW RESOLUTION MECHANISM[1]

Of the €500 bn. pledged on May 9, €440 bn. will be dedicated to the European Financial Stability Fund (EFSF). The fund will guarantee national debts. This is similar but not identical to another proposal, that of creating a European Monetary Fund (EMF), but the EFSF could slide into an EMF if it would provide not just guarantees but also loans. Interest in such a new instrument has suddenly appeared in the midst of the crisis when the governments discovered that there was no mechanism available to effectively bail out Greece and possibly other countries. Was it an omission by the authors of the Maastricht Treaty? Quite to the contrary, as argued above, the intention had always been not to have such an instrument.

The setting up of the EFSF represents a profound change of the euro area. There is nothing sacrosanct about the Maastricht Treaty and improvements can be desirable, but they must be carefully considered. In particular, we need to examine carefully how fiscal discipline would be upheld in this new euro area. As currently discussed, it would rely on two instruments: a strengthened Stability and Growth Pact and tough conditionality.

3.1. A stronger Stability and Growth Pact

I have argued above and in my previous Briefing Note that the Stability and Growth Pact is fundamentally limited by national sovereignty in fiscal affairs. The way around this limitation has been the threat of sanctions. Strengthening the pact really means designing

[1] The remarks that follow are based on preliminary reporting on the May 7 deliberations of Finance Ministers.

tougher sanctions than mere fines capped at 5% of GDP. Various ideas have been advanced, like imposing an interest-free deposit, stopping payments from the Commission regarding Cohesion Funds or suspending voting rights. These would presumably come in addition of the fine scheme already in place.

Punishing a country is a very powerfully symbolic action. Its modern use is rare, extreme in fact: embargoes in the political domain and, in the economic domain, suspension from the IMF for defaulting on official loans. The World Trade Organisation also runs an Arbitration Tribunal that can authorize countries to adopt retaliatory measures. In each case, the procedure is long and exceptional – WTO rulings are more frequent but there a full-fledged tribunal deals with cases submitted my plaintiff countries. The intention with the reformed Pact is, instead, to move fast to the sanction stage. Making sanctions a quasi-routine process would be a unique step in modern international relations.

The only chance for sanctions to be perhaps acceptable is that they be backed by a strong economic logic. Unfortunately, this is not the case. The limits of tolerated deficits are arbitrary, recognizing the cyclical impact is tricky, and fines or deposits have the illogical characteristic of worsening a budget deficit that is already considered excessive. It is a safe bet to predict that sanctions are unlikely to ever be applied and that, if they ever are, the political fallout is bound to be at least as disastrous as the current situation.

3.2. Conditionality

The EFSF's mutual guarantee is meant not be seen as an easy way-out for chronically undisciplined governments. The intention is to impose tough conditions in exchange for the guarantee. This is exactly the way the IMF operates, with reasonable success. "Fear of IMF" is a potent incentive for governments to carry out policies that will keep them from the desperate situation where the only available option is to ask for an IMF programme.

IMF conditionality requires two crucial steps: 1) agreement on a policy programme, which includes a schedule of actions and expected outcomes; 2) regular monitoring of compliance. These are demanding tasks that require a dedicated and experienced staff. Being in charge of 186 countries, the IMF can maintain a high quality staff that is frequently facing crisis situations. With 16 (currently) members, the euro area is unlikely to face frequent enough programme requests to maintain adequate and up-to-date competences in this area. This has been visible during preparation of the Greek programme.

This means that the resolution mechanism will not – and certainly should not – be activated outside of an IMF programme. But then the question is why does the euro area need its own resources? One answer is that several euro area countries are large enough for the IMF to exceed its lending capacity should a few of these countries simultaneously require assistance. Indeed, increasingly the IMF is pooling resources from friendly neighbours to assist a country in difficulty, a solution that is currently forbidden within the euro area by the no-bailout clause. In addition to implicitly acknowledging that mutual assistance is incompatible with the Treaty, this response suggests a simpler solution, frequently used in the past: emergency loans to the IMF in the form of special Agreements to Borrow.

3.3. Governance

Governance of the EFSF promises to be very delicate. €440 bn. amounts to 4.5% of current euro area GDP, about three times the Commission's total budget. Of course, a guarantee does not constitute outright spending but decisions to commit such an amount of taxpayer's money must be subjected to adequate governance. Since there is no plan to create a new institution – which would presumably require a new treaty – it will have to be *ad hoc*. Current plan is to create a Special Purpose Vehicle (SPV). Worryingly, SPVs so far have been the off-balance sheet bank items called "shadow banking". SPVs played a very dangerous role on the way to the crisis because they were largely outside the eyesight of bank supervisors.

Under current plans, the EFSF will be under direct control of member governments, each one with a veto right. This means that it will often prove very difficult to use the shadow fund and therefore that this will be a highly politicized system. The experience with Greece's rescue shows how easily group think can lead political leaders in a dangerous direction. Seeing how easily they have decided to circumvent the very formal no-bailout clause, one can only wonder how they will react in a future crisis when they use a highly informal resource. For examples, guarantees could become outright loans, in a further violation of the no-bailout clause.

4. WHY THE ECB SHOULD NOT SUPPORT GOVERNMENTS IN DIFFICULTY

At the heart of the monetary union lies the objective of achieving price stability. It may seem as a distant objective at this stage but permanent price stability is a delicate feature that can only be guaranteed by proper institutional arrangements. At the heart of any such arrangement lies the principle of dominance.

In any country there exists one budget constraint that requires that current and future spending be matched by current and future revenues. Unless this constraint is satisfied, the public sector is insolvent. Put differently, public sector solvency requires either that current and future spending be brought down to expected current and future revenues or that current and future revenues be raised to finance current and future spending. Which route is taken is crucial, yet it is entirely dependent on future decisions on spending and revenues, which cannot be known with any degree of certainty. This uncertainty carries some extremely important implications.

A first implication explains the current debt crisis in Europe. Under a plausible scenario, Greece could be seen as respecting its budget constraint. Under an equally plausible scenario, it will not. The crisis erupted when the markets concluded that it is unlikely to do so. This conclusion has been described as arbitrary and unreasonable, but it cannot be rejected off hand precisely because of the forward-looking nature of the budget constraint.

The second implication concerns revenues. There are two broad sources of public revenues: taxes and monetary creation. Thus, if the budget constraint is to be met through revenue adjustment, there remains the question of which revenues will be mobilized. If it is established that the central bank will never, under any condition, use its power to create money to guarantee the budget constraint, we have a situation called *monetary dominance* and price stability is guaranteed if it is the central bank's official objective. Otherwise, we have a situation of *fiscal dominance*, whereby the government can freely decide on spending and revenues without worrying about the budget constraint for the central bank can be convinced to make up for any shortfall. Historically, inflation always occurs in a situation of fiscal dominance. Importantly, which dominance is in place is not a matter of fact, but of beliefs based on commitments. As the Greek case exemplifies, markets can quickly shift their beliefs. If they think that monetary dominance is at risk, inflation fears will to exchange rate depreciation, with a direct inflationary impact, and to increases in long-term nominal interest rates, which further deteriorates budget imbalances, triggering a vicious cycle.

This explains why the Maastricht Treaty has so carefully sought to establish monetary dominance (art.123, 125 and 130). It also explains why the ECB has constantly felt the need to warn governments about the threats to price stability created by fiscal indiscipline. It means that the ECB should never, under any circumstances, be involved in an action that can be perceived as potentially undermining monetary dominance.

5. A BETTER WAY

The recent policy actions may have succeeded in stabilizing temporarily the situation. But this is likely to be a temporary victory, achieved at the expense of longer-term concerns, chiefly fiscal discipline and price stability. Trying to make these arrangements permanent by adopting a permanent resolution mechanism and strengthening the implausible Stability and Growth Pact, amounts to institutionalize them.

A better approach would start from five observations:

- For price stability to be guaranteed in the long run, fiscal discipline must be firmly established in every euro area member country.
- Unless a new Treaty is adopted, responsibility for fiscal discipline remains a national prerogative.
- The no-bailout clause has lost much of its credibility and the ECB's own credibility has been hurt.
- The Stability and Growth Pact has repeatedly failed, for fundamental reasons that cannot be addressed unless the Treaty is changed.
- It is very unlikely that a Treaty that significantly reduces national fiscal policy sovereignty can be adopted in the coming years.

Four implications naturally follow:

- A new regime must be instated to fill the vacuum.
- Responsibility for fiscal discipline must be very explicitly decentralized to the national level.
- A corollary of national fiscal policy sovereignty is that each government alone is responsible for its debt.
- There must be urgent peer pressure on every government to establish institutions that have a high probability of delivering fiscal discipline in the long run.

One question is: what are institutions that have a high probability of delivering fiscal discipline in the long run? There is no unique model but several countries offer examples. Belgium, the Netherlands and Sweden have built in checks and balances, relying in part on independent expert judgement. High-level legislation imposes budget balance – sometimes budget surplus – in countries such Germany, Switzerland, Brazil and Chile.

Another question is: why should peer pressure succeed here as it usually fails? One answer is necessity (and hope). We have no instrument to impose the adoption of strong fiscal policy institutions in member countries. Another answer is that the situation is propitious. Virtually every government knows that markets are concerned. The current attitude is to adopt premature spending cuts or tax increases, which risks bring to its end the moderate recovery under way. Giving markets hard guarantees (in high-level legislation) that fiscal discipline will eventually prevail will allow governments to proceed more cautiously with their exit strategies. If a number of countries indeed adopt adequate high-legislation, the hope is that pressure on the others will become irresistible.

The final question is: how do we know that all countries will respect their own rule? We do not know, of course. Those that violate their own fiscal discipline obligations will sooner or later find themselves in today's Greece position. The next time, however, other governments must avoid linking a local debt crisis with the euro area. Letting a country go to the IMF and, if need be, reschedule its debt is the only appropriate response.