Fiscal Policies in Monetary Union

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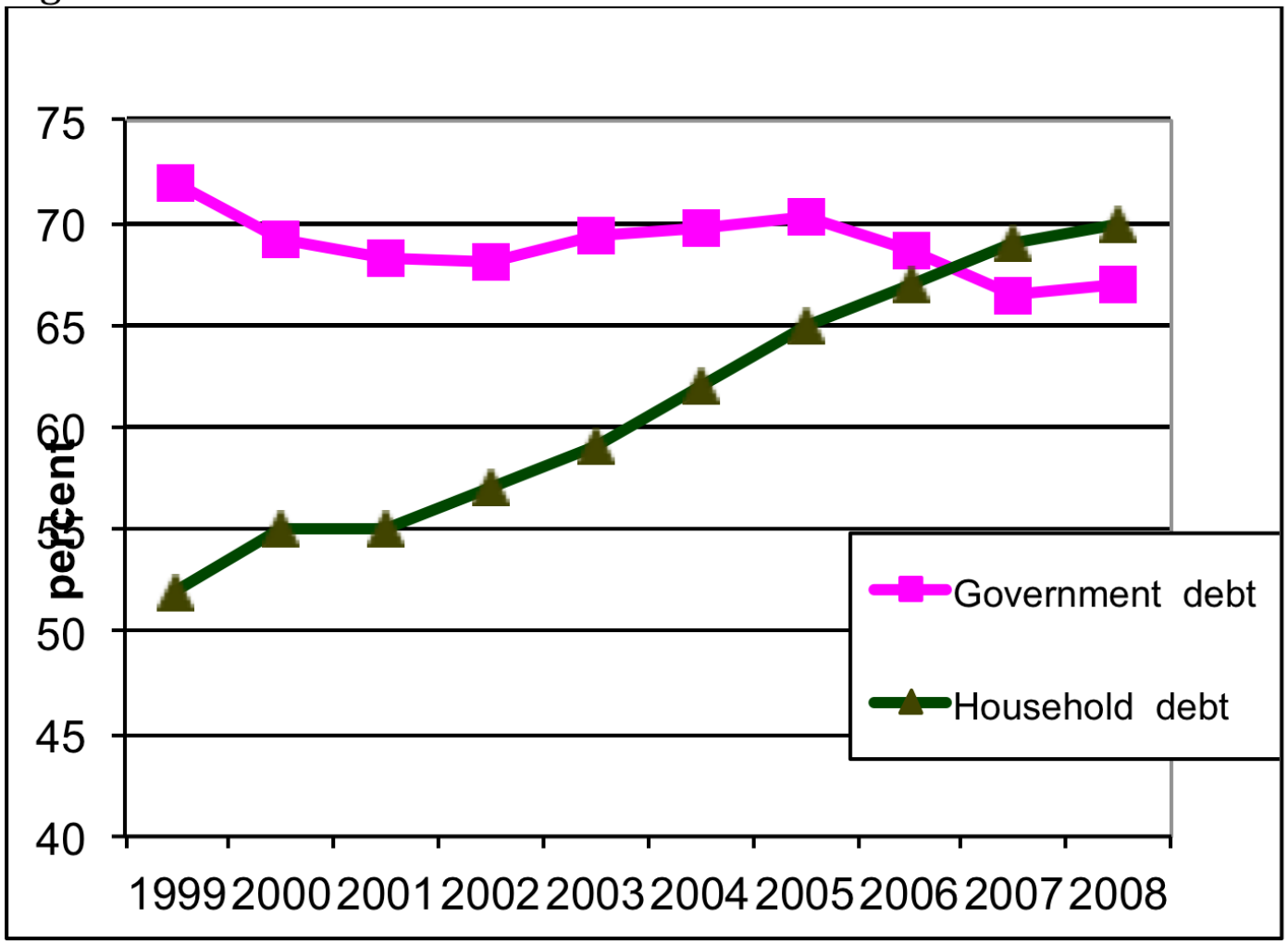
Introduction

- What kind of fiscal policies in a monetary union?
- Dominant view: member countries of MU should be subjected to additional budgetary discipline compared to stand-alone countries
- Two types of models sustain this view
  - Moral hazard risk due to implicit (or explicit) bailout guarantee in MU
  - Common pool problem: fishing from same pool of financial capital leads to overfishing

- This analysis has been very influential.
- It has led to designing control mechanisms on national fiscal policies aimed at maintaining budgetary discipline in the Eurozone.
  - Stability and Growth Pact (SGP) has been tightened considerably,
  - New control procedures have been added in the context of the so-called six-pack and two-pack legislations.
  - Member countries have accepted to introduce balanced budget rules in their national legislations (the Fiscal Pact).

- Surprising thing about this emerging new governance of the budgetary processes in the Eurozone: there is little evidence that the fiscal crisis that erupted after 2008 was the result of government profligacy prior to that date.

Figure 1: Government and household debt in Eurozone

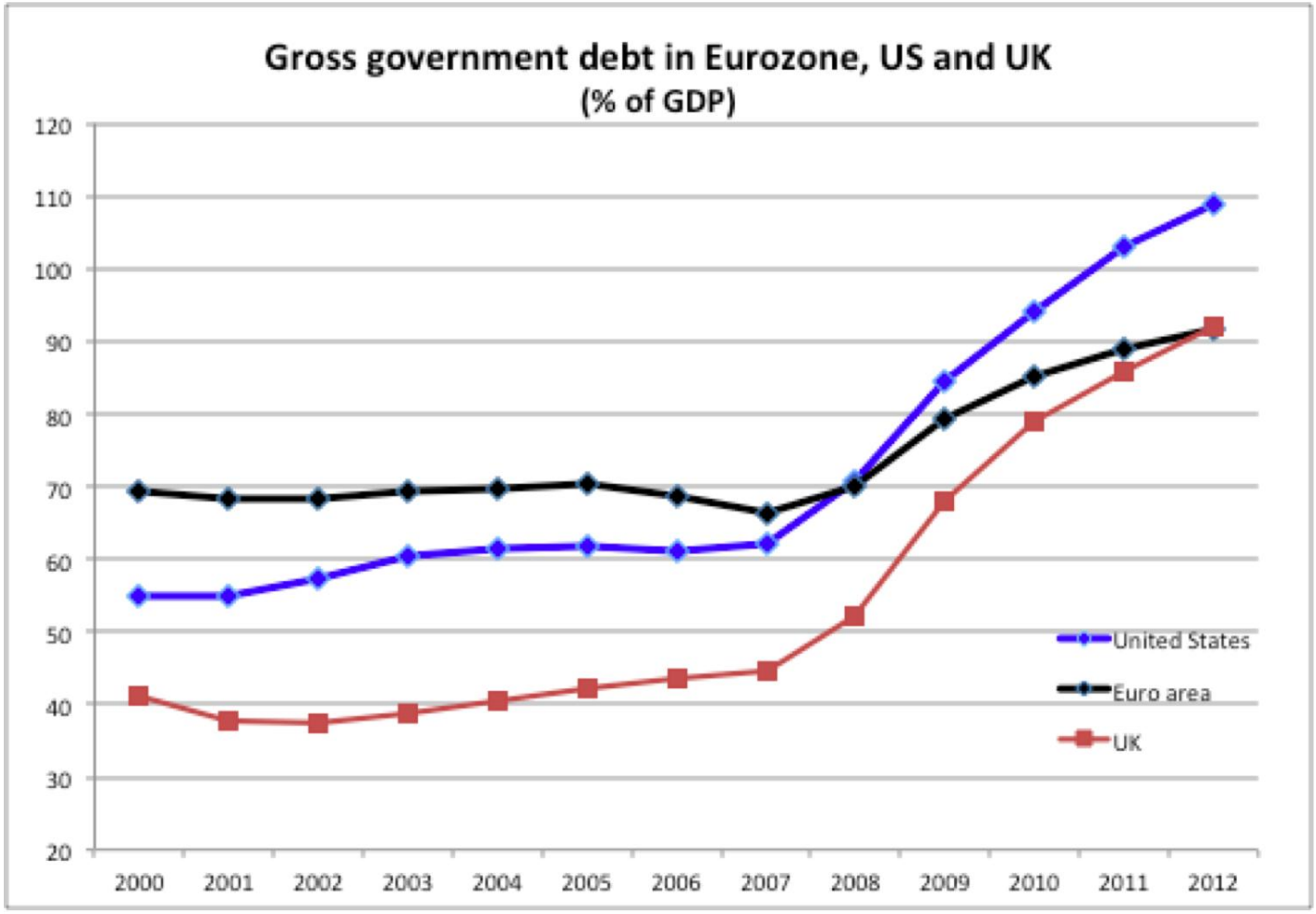


Source: European Commission, AMECO database and CEPS

- Existence of the Eurozone does not seem to have triggered government profligacy as predicted by moral hazard and common pool theorists.
- Note that this was a time when the SGP was considerably more flexible than today, and the six-pack, two-pack and fiscal compact did not exist.
- despite the absence of disciplining devices, the government debt to GDP ratio in the Eurozone was on a declining path.
- If there was profligacy prior to the crisis it was among private households.

- It is now increasingly recognized that the explosion of the government debt ratios after 2008 is the result of a balance sheet recession that was triggered by the desire of the *private* sector to reduce its excessive debt,
- forcing governments to take over the private debt in order to avoid a debt deflation dynamics (Fisher(1936)).
- This dynamics was observed inside and outside the Eurozone.
- In fact it was probably stronger outside the Eurozone as suggested by Figure 2.

Figure 2



Source: European Commission, AMECO database

- Yet the new budgetary governance structure imposed on the Eurozone was completely impervious to this diagnosis
- and created disciplinary institutions based on the diagnosis that the cause of the crisis was government indiscipline,
- which compared to stand-alone countries made it more difficult to avoid the debt deflation dynamics

- Other source of surprise: At the start of the Eurozone a structural change in the nature of the debt of member countries of a monetary union occurred.
  - This structural change arises from fact that when countries joined the Eurozone national governments had to issue debt in a currency over which they have no control.
  - It is as if suddenly these governments had to issue debt in a foreign currency.
- This fundamentally changed the budget constraint of these governments: it hardens the budget constraint
- It is surprising that this fundamental change played almost no role in the theoretical discussions of fiscal policies in a monetary union.

Fragility of the sovereigns in the Eurozone

- Governments of member states cannot guarantee to bond holders that cash will always be there to pay them out at maturity
- Contrast with stand-alone countries that give this implicit guarantee
  - because they can and will force central bank to provide liquidity
  - There is no limit to money creating capacity

Self-fulfilling crises

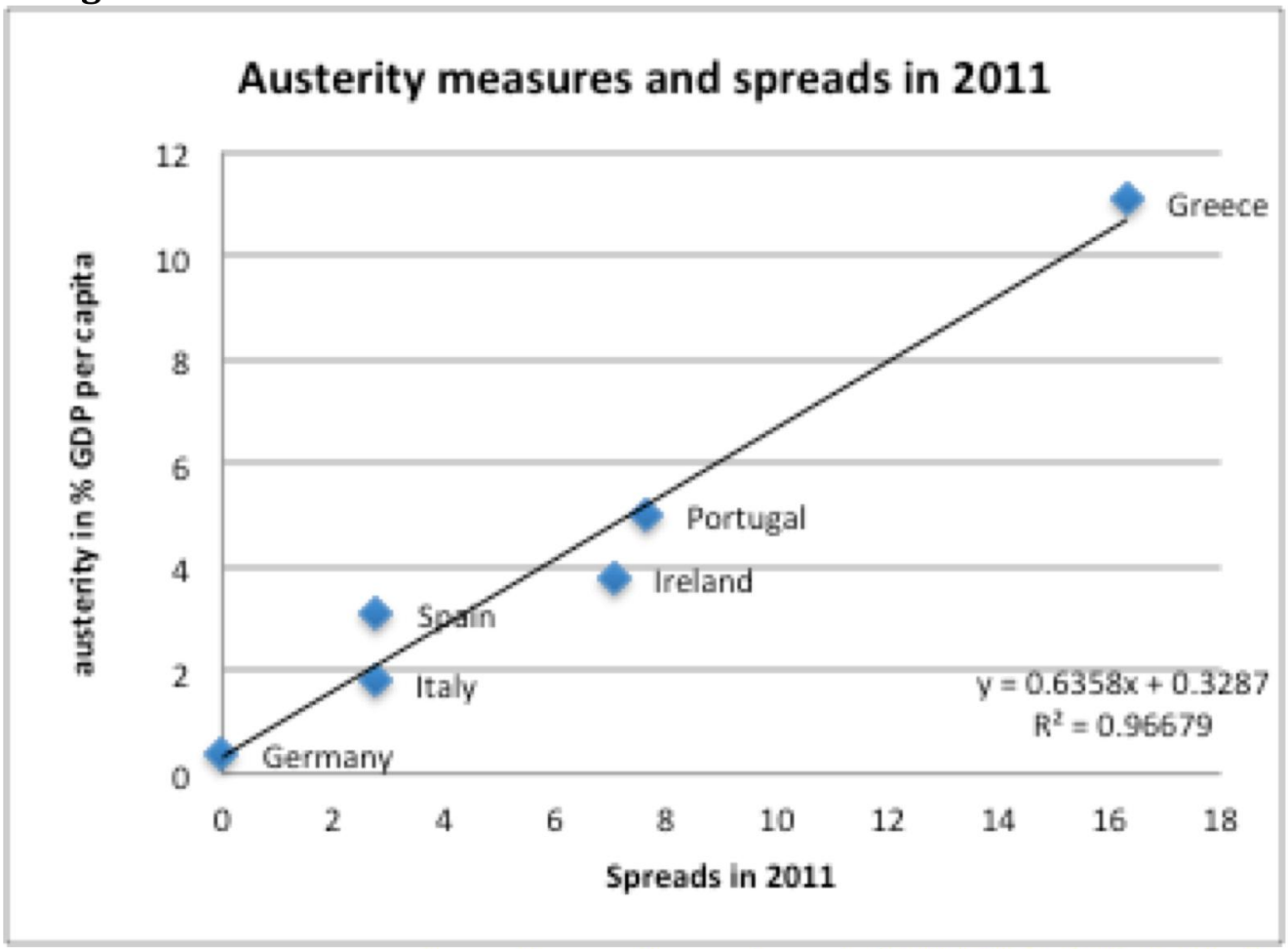
- This lack of guarantee can trigger liquidity crises
  - Distrust leads to bond sales
  - Interest rate increases
  - Liquidity is withdrawn from national markets
  - Government unable to rollover debt
  - Is forced to introduce immediate and intense austerity
  - Producing deep recession and Debt/GDP ratio increases
- This leads to default crisis
- Countries are pushed into bad equilibrium

- This happened in Ireland, Portugal and Spain
  - Greece is different problem: it was a solvency problem from the start
- Thus absence of LoLR tends to eliminate other stabilizer: automatic budget stabilizer
  - Once in bad equilibrium countries are forced to introduce sharp austerity
  - pushing them in recession and aggravating the solvency problem
  - Budget stabilizer is forcefully switched off

- Thus, we found out that financial markets acquire great power in a monetary union:
  - they can force countries into a bad equilibrium characterized by increasing interest rates
  - that trigger intense austerity measures,
  - which in turn lead to a deflationary spiral that aggravates the fiscal crisis.

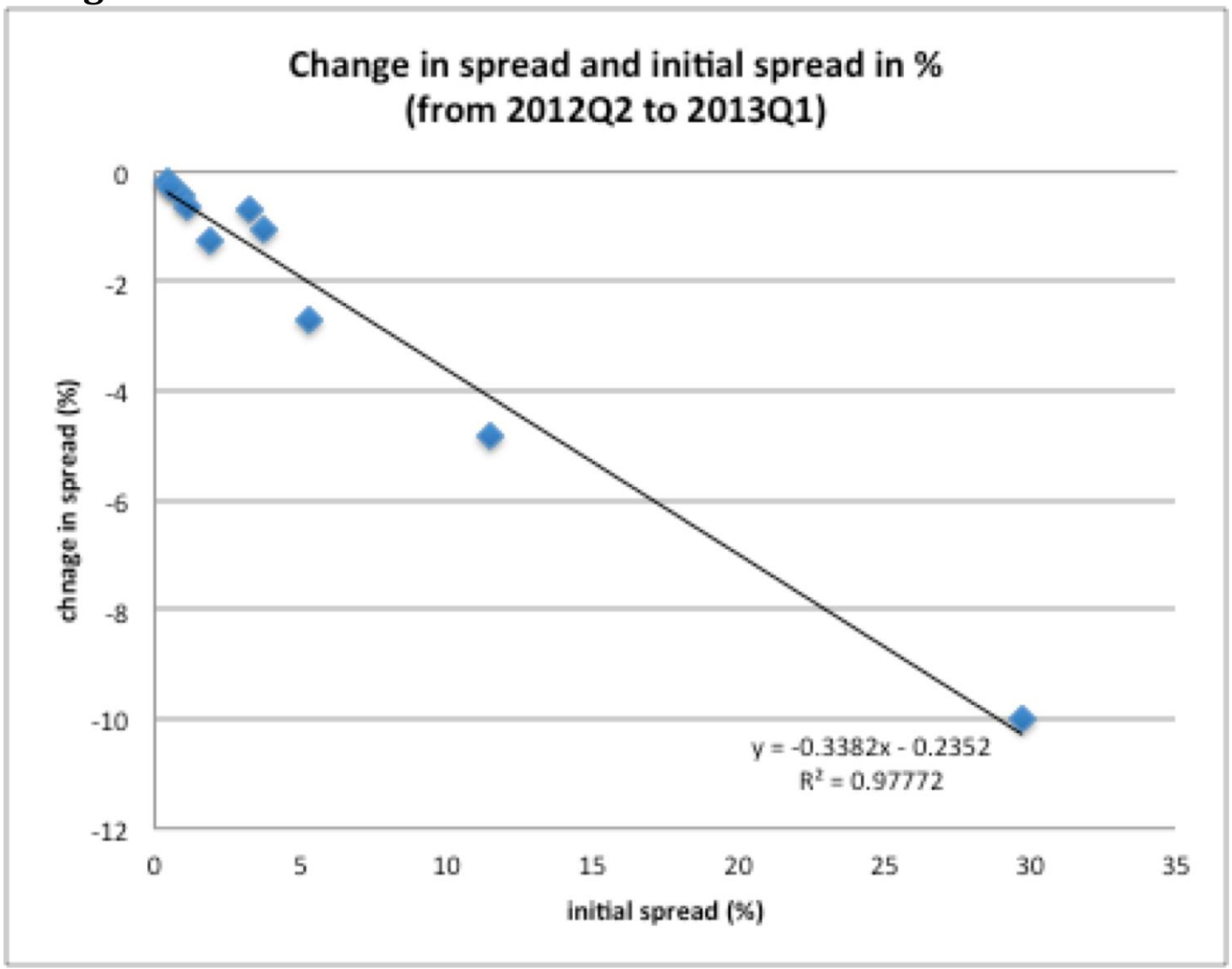
Some empirical evidence

Figure 3



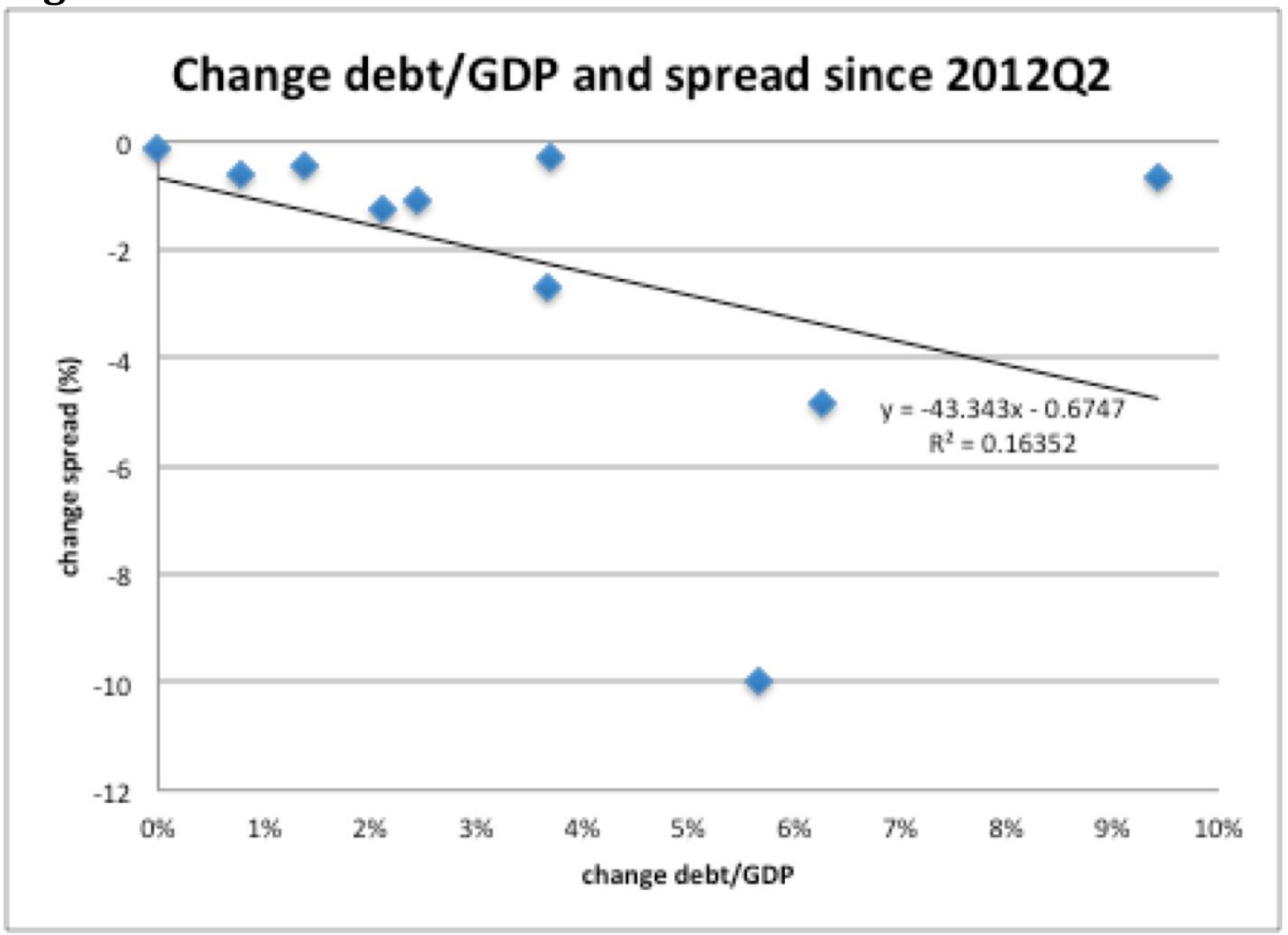
Source: Financial Times, http://www.ft.com/cms/s/0/feb598a8-f8e8-11e0-a5f7-00144feab49a.html#axzz2JSOwncys and Datastream

Figure 4



Source: Datastream (Oxford Economics)

Figure 5

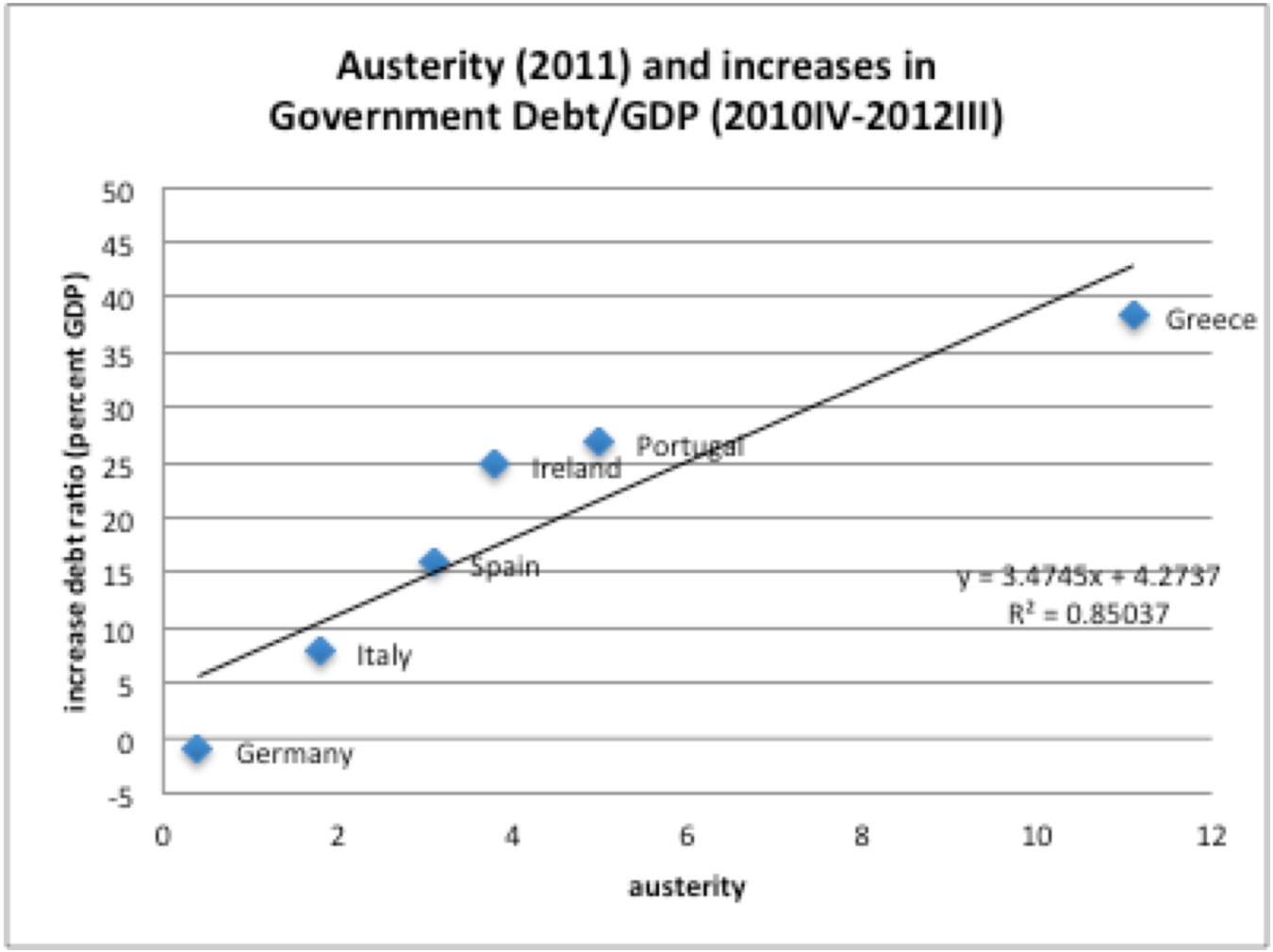


Source: Datastream (Oxford Economics)

Interpretation

- As the spreads increased due to market panic, these increases also gripped policy makers.
- Panic in the financial markets led to panic in the world of policymakers in Europe.
- Result of this panic: rapid and intense austerity measures on countries experiencing these increases in spreads.
- Instead of being a machinery of budgetary indiscipline, the Eurozone became a vehicle imposing excessive discipline on member countries.
- Intensifying the debt deflation process in Southern countries

Figure 5



Source: Financial Times, http://www.ft.com/cms/s/0/feb598a8-f8e8-11e0-a5f7-00144feab49a.html#axzz2JSOwncys and Datastream

Note: The Greek government/debt ratio excludes the debt restructuring of end 2011 that amounted to about 30% of GDP

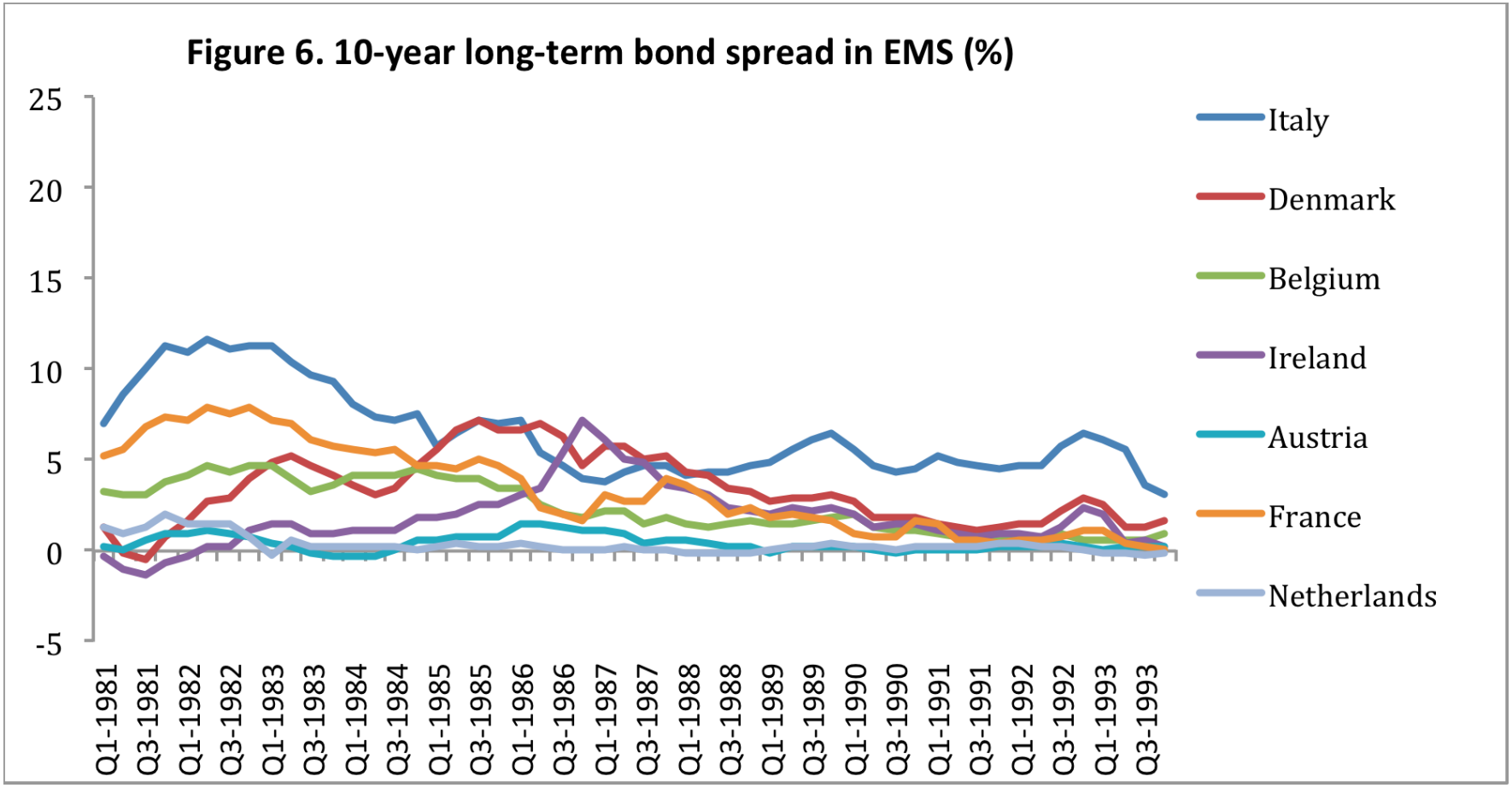
- This dynamics had much to do with the fact that the member countries governments' were structurally weakened in that they lost their natural ally, the local central bank as a lender of last resort.
- As a result financial markets ruled supreme

More evidence that spreads were driven by panic and fear

- We compare spreads in Eurozone and EMS
- EMS: central banks promised to convert their liabilities into a currency, the mark, they did not have
- Eurozone: governments promised to convert their liabilities into currency, the euro, they do not have
- Note: in EMS, governments promised to convert their liabilities in a currency, their own, that they fully controlled

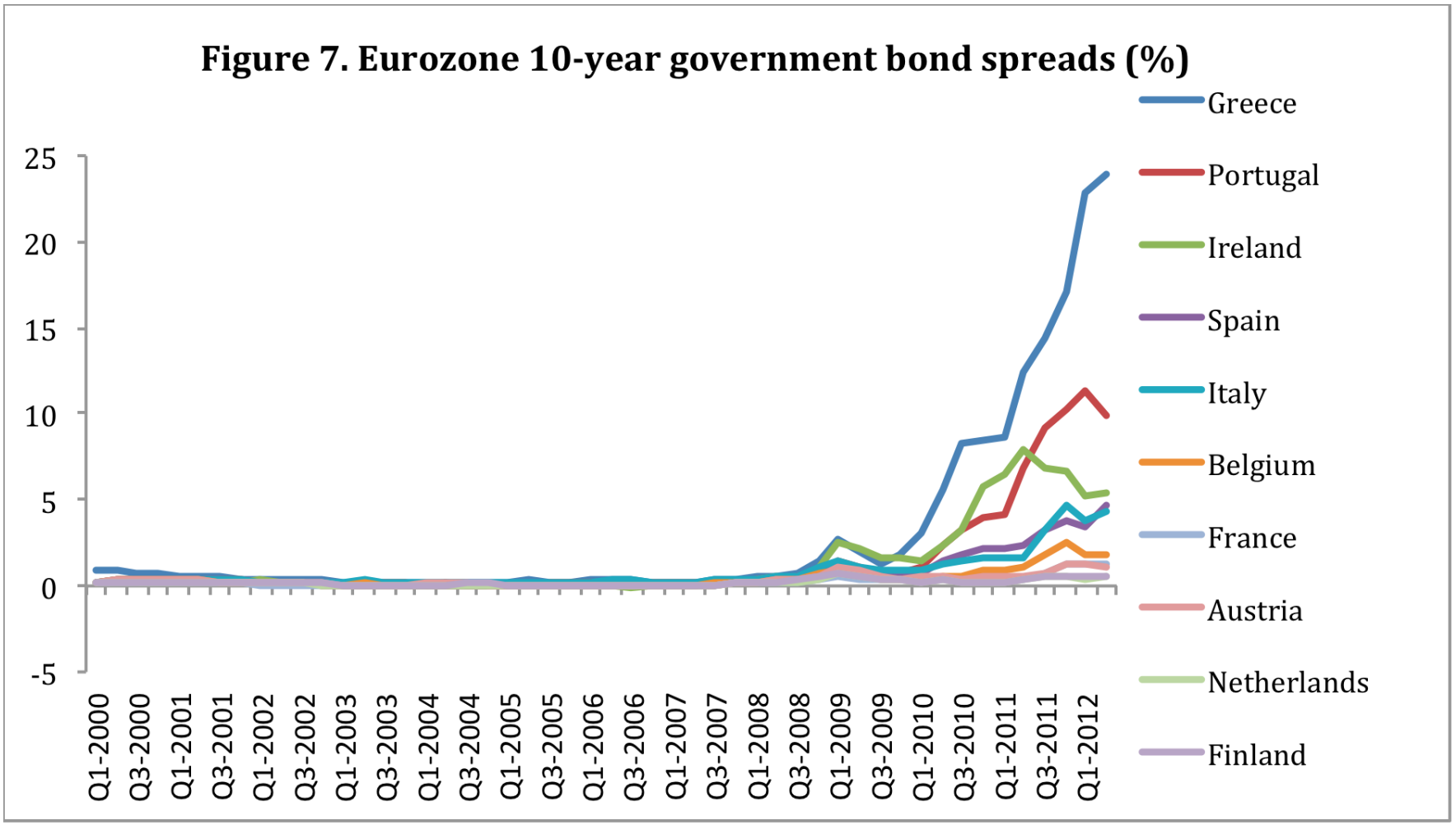
- This difference allows to compare the government bond spreads in these two monetary regimes.
- We expect that in Eurozone, government bond spreads can be gripped by market sentiments (panic and fear)
- Not so in EMS (although crises can occur in foreign exchange markets)

The data



Data source: Datastream (Oxford Economics)

Figure 7. Eurozone 10-year government bond spreads (%)



Data source: Datastream (Oxford Economics)

Econometric analysis

$$S_{it}=\alpha+\beta F_{it}+ \alpha_i+\gamma_t+u_{it} \qquad (2)$$

- S_{it} is the interest rate spread of country *i* in period *t*,
- α is the constant term and
- α_i is country *i*'s fixed effect.
- F_{it} is a set of fundamental variables that are specific to the two different monetary regimes
- γ_t is time dummy variable; it measures the time effects that are unrelated to the fundamentals of the model. If significant, it shows that the spreads move in time unrelated to the fundamental forces driving the yields.

Table 1. Long-term government bond spread (%) in EMS period (1981Q1-1993Q4)

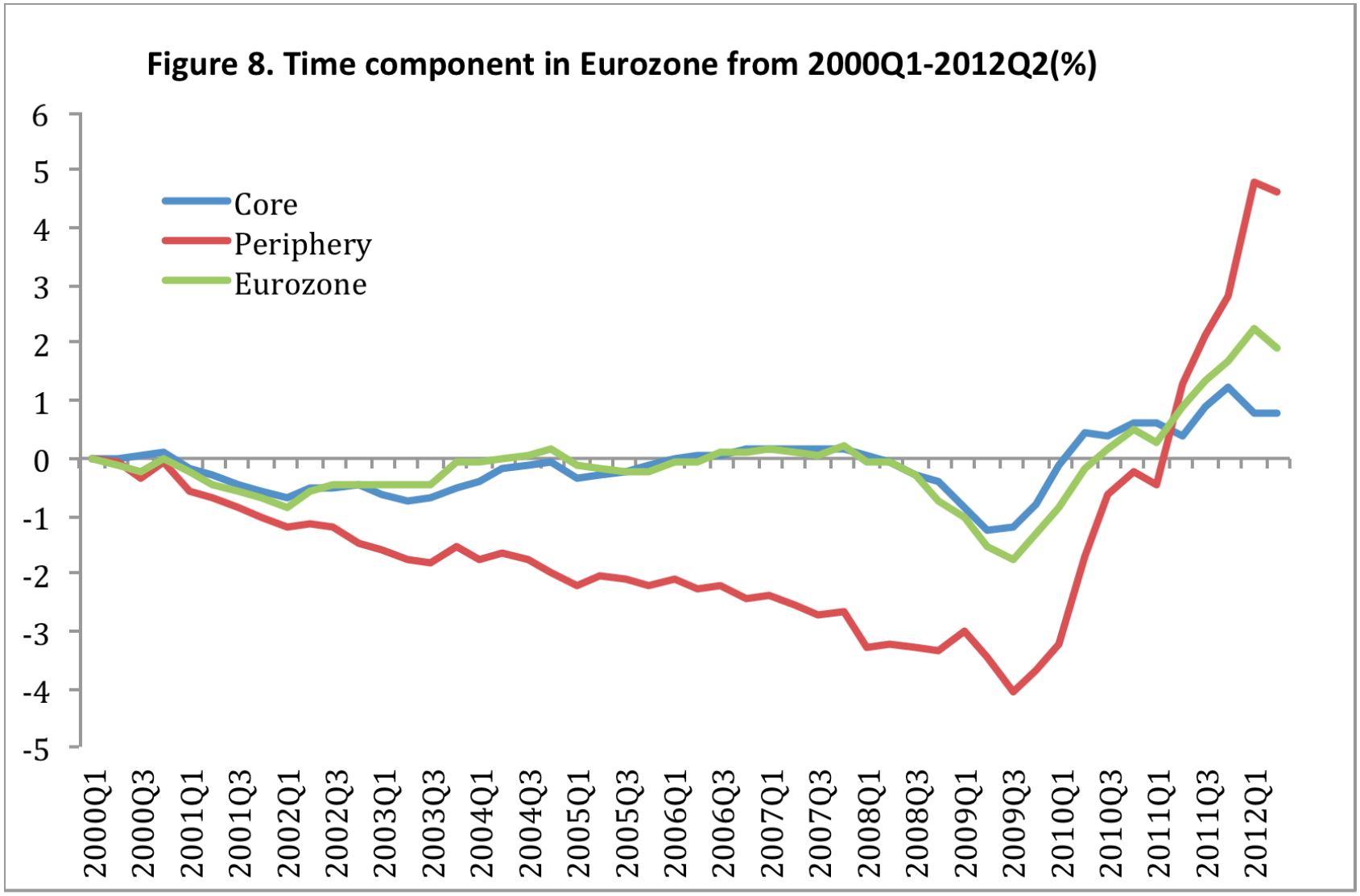
	(1) Pooled	(2) Pre-1987	(3) Post-1987
Debt/GDP ratio	0.0292	0.0834*	0.0415***
	[0.0252]	[0.0370]	[0.0077]
Accumulated current account/GDP ratio	-0.0853	-0.2330***	-0.0337
	[0.0482]	[0.0478]	[0.0384]
Real effective exchange rate	-0.0128	0.0180	0.0467*
	[0.0478]	[0.0714]	[0.0191]
Growth rate	0.0991	0.0365	0.0017
	[0.0665]	[0.1178]	[0.0341]
Inflation differences	0.2431	0.2213	0.3086***
	[0.1754]	[0.1718]	[0.0780]
Change in exchange rate	0.2448*	0.2787***	0.1326***
	[0.1165]	[0.0479]	[0.0339]
Observations	364	168	196
R^2	0.6974	0.8226	0.8748
Hausman test for fixed effect model		Prob>chi2 = 0.0000	
Chow test for structural break		Prob > F = 0.0000	
Time fixed effect F test		Prob > F=0.4808	

Cluster at country level and robust standard error is shown in brackets. * p < 0.1, ** p < 0.05, *** p < 0.01

Table 2. Long-term government bond spreads (%) of Eurozone (2000Q1-2012Q2)

	(1) Pooled	(2) Pre-crisis	(3) Post-crisis	(4) FT model
Debt/GDP ratio	-0.0901***	-0.0114	-0.0892**	-0.0968**
	[0.0254]	[0.0066]	[0.0387]	[0.0379]
Debt/GDP ratio squared	0.0011***	0.0001	0.0008**	0.0007**
	[0.0002]	[0.0001]	[0.0003]	[0.0003]
Real effective exchange rate	-0.0185	-0.0149***	-0.2156	0.0293
	[0.0466]	[0.0024]	[0.2331]	[0.0361]
Growth rate	-0.1070*	-0.0008	-0.1145	-0.2058**
	[0.0511]	[0.0037]	[0.0853]	[0.0873]
Accumulated current account/GDP ratio	-0.0192	0.0003	-0.1845*	-0.0301
	[0.0122]	[0.0016]	[0.0834]	[0.0186]
Observations	500	320	180	500
R^2	0.7193	0.7088	0.8297	0.8724
Hausman test	Prob>chi2 =0.0000			
Chow test	Prob > F = 0.0000			
Time fixed effect F test	Prob > F=0, "no time effect" hypothesis is rejected			

Cluster at country level and robust standard error is shown in brackets. * p < 0.1, ** p < 0.05, *** p < 0.01



Source: authors' own calculations from regressions in Table 2(4).

Conclusion

- The nature of fiscal policies was changed dramatically by the creation of the Eurozone.
  - Prior to the start of the Eurozone, national governments were sovereign in that they could back up the issue of debt by the issue of money
  - Since then they lost this sovereignty in the Eurozone.
  - This had dramatic effects that were largely overlooked by the designers of the Eurozone.

First effect

- This structural change made sovereigns vulnerable to self-fulfilling liquidity crises that could push these governments into insolvency.
- Thus, financial markets acquired great power over the sovereigns in that they could force them into default.
  - Before entering the Eurozone these same sovereigns could not be forced into default by financial markets because they possessed an ultimate liquidity backstop.
- The member countries of the Eurozone were downgraded to status of emerging countries that lack the capacity to issue debt in their own currencies and that face the same vulnerability ("original sin").

- Only in 2012, thee years after the start of the sovereign debt crises in the Eurozone, did the ECB accept a role of lender of last resort in the government bond markets in the context of its OMT program.
- This had an immediate stabilizing effect and led to rapid declines in the government bond spreads that we illustrated in this paper.

- This is good news for the future of the Eurozone.
- However, up to now the power of the ECB has been exerted only by announcement.
- If market sentiments were to turn around again, the ECB would be forced to intervene.
- Intervention will be necessary if the ECB wants to avoid losing its credibility and its power.

Second effect

- Loss of monetary sovereignty by national governments forced these governments to switch off the automatic stabilizers in the budget when pressured by financial markets.
- This feature became prominent after 2009 when financial markets forced intense austerity in the countries of the periphery.
- Thus by entering the Eurozone, member countries lost much of their capacity to use fiscal policies as a stabilizing instrument when they needed it most.
- And nothing was created at the Eurozone level to compensate for the loss of fiscal policies as a counter-cyclical instrument.

- Much of the social progress of the last century has consisted in giving national governments the capacity to protect its citizens, at least partially, against the instability of capitalism.
- The creation of the Eurozone has dramatically weakened national governments in their capacity of providing such a protection,
- The weakening of the national governments in the Eurozone threatens to undermine the social responsibilities of national governments,
- and in so doing threatens their legitimacy.
- Surely this is not sustainable.