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How much Fiscal Discipline in a Monetary Union?

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ABSTRACT

The nature of fiscal policies was changed dramatically by the creation of the Eurozone. While 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, they lost this sovereignty in the Eurozone. This had dramatic effects that were largely overlooked by the designers of the Eurozone. First it made self-fulfilling liquidity crises possible that degenerated into solvency crises. Second, it led to the imposition of intense austerity program. We provide empirical evidence for these two effects. We argue that contrary to what was expected, i.e. that a monetary union loosens fiscal discipline, it actually leads to too much fiscal discipline.

1. Introduction

What kind of fiscal policies in a monetary union? This is one of the most researched questions in the literature of optimal currency areas. The dominant view that has emerged from this literature is that national governments of member countries of the union should be subjected to additional budgetary discipline compared to stand-alone countries. This conclusion is based on two types of models. The first one relies on moral hazard. Governments in a monetary union are more likely to profit from an implicit (or explicit) bailout guarantee than stand-alone countries. Such a guarantee inevitably leads to moral hazard risk and thus necessitates additional budgetary discipline and a control mechanism that will enforce discipline. The second model is based on a common pool argument. Member countries of a monetary union "fish from the same pool of financial capital". This will then lead to overfishing, i.e. to excessive issue of government debt. The same conclusion follows: in a monetary union, governments of member countries must be subjected to a control mechanism that enforces budgetary discipline.

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. Thus since the outbreak of the sovereign debt crisis in the Eurozone, the Stability and Growth Pact (SGP) has been tightened considerably, including the imposition of quasi-automatic sanctioning of governments which fail to abide by the rules. New control procedures have been added in the context of the so-called

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six-pack and two-pack legislations. Finally, member countries have accepted to introduce balanced budget rules in their national legislations (the Fiscal Pact).

The surprising thing about this emerging new governance of the budgetary processes in the Eurozone is that there is so little evidence that the fiscal crisis that erupted after 2008 was the result of government profligacy prior to that date. In Fig. 1 we show the evolution of government and household debt (as a percent of GDP). The striking feature is that the government debt ratio in the Eurozone was on a (slightly) declining path, while the household debt ratio increased steeply. Thus the 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. That is, the disciplinary mechanism that according to the moral hazard and common pool theorists should be in place to prevent government indiscipline in a monetary union did not exist. Yet 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, 1933; Schularick, 2012). This dynamics was observed inside and outside the Eurozone. In fact it was probably stronger outside the Eurozone as suggested by Fig. 2. 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.

The new governance of the national budgetary processes is a source of surprise for another reason. At the start of the Eurozone a structural change in the nature of the debt of member countries of a monetary union occurred. It went almost unnoticed, however (see De Grauwe, 2011). This structural change arises from the fact that when countries joined the Eurozone the 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 is surprising that this fundamental change has played almost no role in the theoretical discussions of fiscal policies in a monetary union.

In the next section we discuss in more detail the nature of this structural change and we will argue that this change led to a weakening of the sovereigns in the Eurozone. This has affected the nature of fiscal policies in the Eurozone and instead of leading to too little in fact has led to too much budgetary discipline.

2. The fragility of the sovereigns in the Eurozone

When the Eurozone was started a fundamental stabilizing force that existed at the level of the member-states was taken away from these countries. This is the lender of last resort function of the central bank. Suddenly, member countries of the monetary union had to issue debt in a currency they had no control over. As a result, the governments of these countries could no longer guarantee that the cash would always be available to roll over the government debt. Prior to entry in the monetary union, these countries could, like all stand-alone countries, issue debt in their own currencies thereby giving an implicit guarantee that the cash would always be there to pay out bondholders at maturity. The reason is that as stand-alone countries they had the power to force the central bank to provide liquidity in times of crisis.

What was not understood when the Eurozone was designed is that this lack of guarantee provided by Eurozone governments in turn would have important destabilizing effects. First, it could trigger self-fulfilling liquidity crises (a sudden stop)

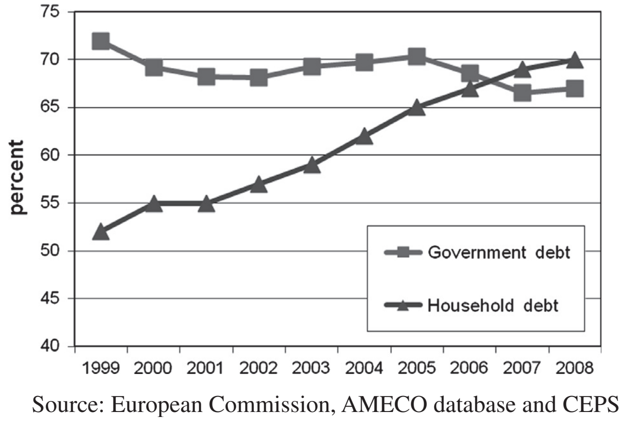

Fig. 1. Government and household debt GDP ratio in Eurozone.