Theoretical and Applied Economics
Volume XVII (2010), No. 8(549), pp. 53-62

Public Debt Evolution in the Eurozone and the Need of Policy Coordination

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Abstract. *The Eurozone sustainability could become a real challenge in the current economical environment, characterized by uncertainty and lack of credibility. The issue of public debts represents a threat for the European financial system, while the coordination process of the economic policies at the Union's level is almost inexistent. The extremely high discrepancies between the budgetary balances of the member states makes the SGP or the strict fiscal rules become an utopia. The discretionary application and lack of credibility induced by SGP have worsened the perceptions on the economic system on European level, and the authorities' answer was not coherent enough, leaving room for interpretation by the Euro-skeptics.*

Keywords: policy coordination; optimum currency area; monetary integration; fiscal policy; stabilization.

JEL Codes: E62, E63.
REL Codes: 8K, 20G.

The lack of symmetry of economic shocks is a cost deriving from the integration in an optimum monetary zone. The problem becomes more sensitive as the economic structure and, especially, the exports' structure is becoming less diversified. The aspect of the diversification degree was intensely analyzed by Peter Kenen (1969), while various studies indicate that the tendencies in case of joining an optimum monetary zone are towards specialization. So, each country will become focused in the fields in which it holds a comparative advantage. At the level of the entire system, the economic structure will be less diversified, creating the premises for a weak correlation of the business cycles. It is an unwanted situation, but the studies performed on USA have proved it in an empirical manner. The problem becomes more sensitive in the Eurozone, due to the lack of a fiscal authority destined to inject capital incentives in the case of an accentuated decrease of the output. Sachs and Sala-i-Martin (1991) have indicated that over 40% from the shocks suffered by the American states are absorbed through the federal fiscal system. The lack of this mechanism attaches an additional cost to the Eurozone level, while the premises for creating a common fiscal block having this power seem extremely low. The moral hazard and chronic deficits existing in certain member states seem to be a barrier which cannot be crossed in the path towards a central fiscal body. In addition to these considerations, we must not forget that the historic evidence at the European Union level is not at all gratifying. I think a pretty relevant clue is offered by Simona Talani in "The Future of EMU": "*We must not underestimate the importance of moral hazard. The experience of many states in which the governmental budget is centralized and distributes large transfers to certain regions (eastern Germany, southern Italy, southern Belgium) is unhappy. These transfers persist for decades and seem to be the main reason for which these regions are never adjusted*".

It is obvious that the problem will persist in time due to multiple factors. The richer states will not rush to introduce additional distributive mechanisms, due to the political loss on national level. How could the authorities in Germany explain the necessity of some significant redistributed aids towards the less developed states in the system? The need of investments in the public sector is continuous in this states also, so the central budget does not allow too large maneuver ranges. Even in case the occurrence of these additional distributive mechanisms were possible, how would the less developed states perceive the transfers they should render in case the rich states suffer an exogenous shock?

The problem appears when the countries' economic evolutions become increasingly divergent. The appearance of the Euro was perceived as a success, but also as a threaten to other powers at the global level. Together with the extension of the Eurozone and the inclusion of other states in the system, the problems seem to multiply. These new members are marked by a series of important or less important issues that affect the monetary union:

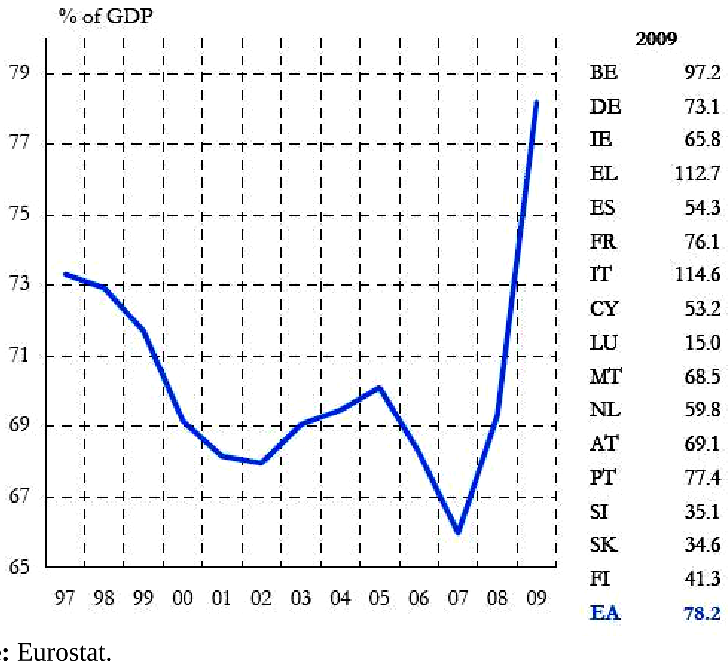
- Inefficient economic restructure;
- Supersized public sectors and even large social transfers that could be permitted by the future budget projections;
- Industries directed on producing goods with low value added and high consumption of raw materials which determine an extremely rigid and inflexible costs structure;
- Questionable sustainability of pension systems and public finances;
- Low developed infrastructure which reveal raising transport costs and reduces trade;
- Big discrepancies in the competitiveness of current and future economic situation between the developed and the new member states caused by inefficient salary policies promoted by the authorities.

The stabilization and adjustment in the system could become a target extremely hard to reach. The common monetary policy may have a strong pro-cyclically influence for the Member States, the ones with high economic growth and even higher inflation rates will confront with low real interest rates, while the other ones will be affected by higher real interest rates. The monetary policies will induce a perverse effect, they will slow the volume of credit for consumption and investment where it is needed and grow it where it is not (Enderlein, Goodhart, 2006). The renounce to the local currency should not determine a high cost. However we should not forget that the situation was far from perfect before the introduction of the common currency. Before 1999 the exchange rate didn't protect the states by eventually external shocks because its level counted other factors and was not exclusively determined by the volume of traded goods and services. The whole approach has to evade one thing, the unemployment rate must not always raise when an adverse shock affects the economy. If the prices and salaries would rapidly and automatically adjust, then the utility of an optimum currency area would become null. But the reality shows that the economy suffers from structural rigidities and the prices and salaries do not adjust automatically.

De Grauwe suggests in his studies that the long term existence of the European project is exclusively dependant on the performance of a political unification. A vision that is concordant with the one of other supporters of a federal system on European level that will be able to continue the integrative process. De Grauwe's thesis suggests that this political unification would reduce the impact of asymmetric shocks and would tighten the political bonds so much needed in the moments when the states in the Eurozone have divergent evolutions. This institutional movement would counteract one of the great issues of the European construction, the democratic liability and legitimacy. The politicians on national level continue to suffer consequences for the adopted fiscal decisions, which many times become unpopular in case of extended recessions. The transfer of these decisions at the level of the European institutions would create a real problem, since they do not assume any kind of political responsibility. How can the European system prevent the free-rider behavior or the neighbor's deprivation politics? Are there other levers aside from the disputable construction represented by SGP?

The choice of the Maastricht criterions tried to regulate this issue, a Monetary Union in which states are strongly differentiated through public debt could create pressures on the inflation rate and common currency credibility. Meanwhile, the states with high public debt would face a growing sovereign risk, so how should we find the optimal authorities approach? The Maastricht Treaty clarified this dilemma introducing the "no bailout" clause through which the monetary authority of the national governments could not be forced to save a member which faces hard problems. However, the Greece case demonstrated the solutions in the reality could differ from the theoretical ones. Nowadays the public debt problem in the Eurozone became extremely serious and could bring large prejudices to the future system functionality. Some part of the fault could be attributed to SGP, which does not bare the necessary force to adjust the budget criterion and cannot represent an efficient punitive mechanism in case of eventually budget slide-slips by the states. In order to clarify the public debt problem we should reiterate the factors that influenced this process. The difficult situation of the Eurozone and the speculative pressures on the common currency are not random. The Euro appearance in the 1999 created a situation without precedent for the European monetary system. Along with the costs derived from the accession in the Monetary Union, the states confronted with a series of real benefits. The elimination of the exchange rate uncertainty represented the big present for the new members that adhered to the last stage imagined by the Delors report. Unfortunately, this gift proved to be a Trojan horse and the consequences can be observed nowadays. Even if it comes to your surprise, the public debt has its origins in the beginning years of the Eurozone.

Analyzing the public debt graph for the Eurozone in the period 1997-2009, we will observe some interesting features. The period precursory to 1999 was marked by a common effort of the states to reduce the weight of public debt in GDP in order to meet the criterions of the Maastricht Treaty. Despite all the efforts, the rapport between public debt/GDP calculated as an average for the Eurozone could not be lowered under 60%, even if it recorded a descendent trend. Along with the construction of the Monetary Union and the Euro appearance the trend starts to reverse. We can remark an inflexion point in 2001, a difficult year for the American economy because of the dot-com bubble. The crisis extended to Western Europe reducing the interest rate in order to adjust the external shock. The ascending trend of public debt was continuously influenced by the governmental injections destined to adjust the macroeconomic disturbances. The public debt average for the Eurozone reached a minimum point of 66% in 2007 followed by a strong ascendant trend which still marks the current situation. Which was the principle cause for the suddenly appearance of the inflexion point?



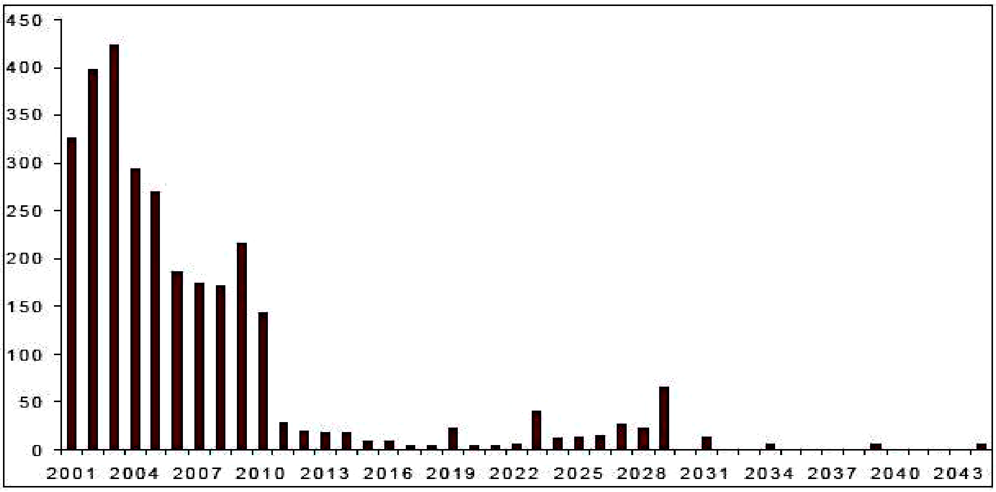
Source: Eurostat.

Figure 1. *Public Debt Evolution in Euro Area (1997-2009)*

Many scientists believe that the escalation of the economic problems in the US in 2007 has strongly influenced the developed European states' economies. Indisputable, the American crisis has had a great impact over the economic evolutions of many European states, especially Great Britain and Ireland, which strongly rely on the Anglo-Saxon banking system. This model has shown its boundaries and has created real problems regarding developed economies.

Unfortunately the crisis of public debt on European level was also fed by another important factor. Next to the massive public injections caused by governmental interventions, the Eurozone was confronted with another issue. Together with the integration in the Monetary Union, a large part of the European states began to profit from a specific situation. Both in the public and the private sector, they have taken advantage of the opportunity arisen together with the disappearance of the exchange rate between national currencies. The issuing of state or corporative bonds had an ascendant tendency after 1999 for two reasons: one closely connected with the significantly smaller interest rates, which did not include the exchange rate and had attached the credibility of the single currency, and the second, related to the duration of these bonds. The states could now roll the public debts on longer periods, taking advantage of a higher maturity.

The first cycle of debts had a maturity average between 4 and 6 years, with differences between the more powerful states with a higher credibility (Italy – 6.1 years, Germany – 6.8 years, France - 6,2 years) and the ones from the Mediterranean group (Portugal – 4.7 years, Greece – 5.2 years, Spain – 5.5 years). The first cycle reached maturity beginning with 2004 and the largest part of the debt was accumulated in a period of time extended until 2007. The breach on SGP in 2002 and 2003 by Germany and France was to indicate a smaller credibility degree of this mechanism designed to supervise the fiscal evolutions in the member states. Without a strong coordination at the Eurozone level and with an entire series of states with "free-rider" behavior patterns, the situation could not have a favorable end. The descendent trend of public debts was reversed after the appearance of the single currency, due to the disappearance of a strong fiscal mechanism with this purpose. The Growth and Stability Pact did not have the necessary strength to control it and the Maastricht criteria became a real problem for the states wishing to adhere to the Eurozone, but not for the ones already integrated in the system.



Source: BCE – Bond Market Report 2001.

Figure 2. *Euro area government bond maturity (mld. Euro)*

A first rolling of the debts was possible upon the completion of this cycle, as indicated by the analysis date of the Central European Bank. A large part of the debts that managed to be rolled with the help of the secondary or primary market had a new maturity peak in 2008 and 2009. Unfortunately, no one could have anticipated that this cycle will overleap the financial crisis bursting in 2008, and the possible rescheduling of the debts will be extremely hard to perform, especially in the states with delicate fiscal positions. In addition, we must not forget the issue of budgetary deficits, becoming extremely sensitive with the massive injections of public funding. The eternal issue of the states with large structural budgetary issues that cannot be automatically regulated and in which the automated stabilizers have a significant role continued to exercise a high amount of pressure. It seems that the situation is also suffering due to an endless string of factors, with negative influence on the entire development.

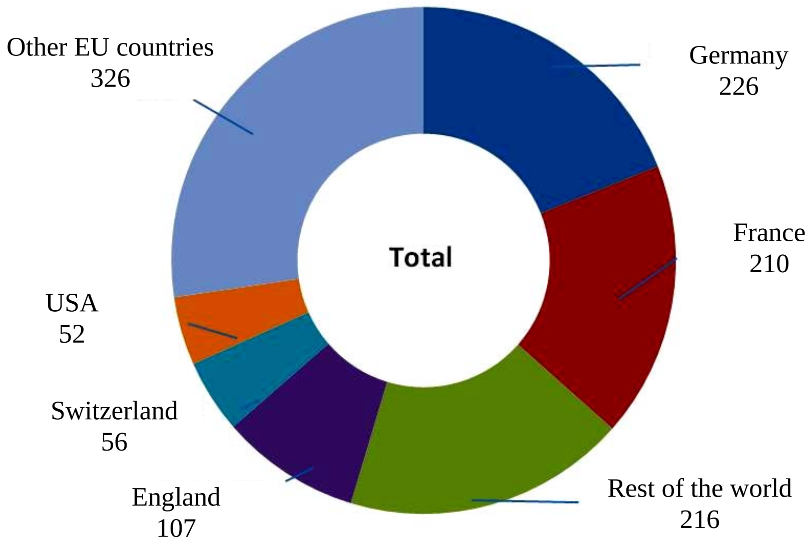
Source: Bloomberg, estimation Deutsche Bank.

Figure 3. *Euro area government bond maturity profile (mld. Euro)*

Without a doubt, the first states affected by it were the ones included under the generic denomination PIIGS. Once this debt crisis became more acute, the entire credibility of the Eurozone was to suffer and the no bailout politics seemed not to operate, due to various reasons:

- No one can anticipate the real loss suffered by the Monetary Union in case a member state would become bankrupt
- A large range from the state bonds issued by Greece, Portugal and Spain are held by banks in Germany, France and, in other words, these states would be put in a delicate situation, and either willingly or not they have to come up with a plan to save Greece and other states in difficulty.

It might be possible that the biggest problem of the Eurozone is the lack of a joint fiscal system that may absorb a large part of these shocks. But, this type of supranational institution can not be incorporated without a larger political unification, consolidating the coordination of economic politics, as De Grauwe was anticipating in his analysis in 2010: "*Joint solidarity can not be avoided in the Monetary Union, even if it means having dinner with sinners*".



Source: Bank for International Settlements.

Figure 4. *Foreign Banks Exposure in Greece, Portugal and Spain*

The rising exposure in the PIIGS states creates an unpleasant situation for the authorities in the Western European States. The plan performed with the help of the IMF and the national governments was destined to inject credibility and ease the speculative pressures on Euro. Meanwhile, we have to take into account that the structure of the private debt is clearly affected by the current economic crisis. The trouble could become even larger if we analyze the future budget projections for the European states. The crisis has dried the financial markets which reacted by restricting credit and raising the premium risk. If the coordination process in the system would function better in the future and the national governments maneuver would become perfectly correlated then the situation would appear more optimistic.

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