

Bohn, Henning; Issing, Otmar; Westermann, Frank

## Article

# The European Monetary System: Deficits and Cures

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## Panel 1: The European Monetary System: Deficits and Cures

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Prof. Henning Bohn  
Professor of Economics, University  
of California, Santa Barbara

I appreciate the invitation to participate in honoring Hans-Werner Sinn. I have known Hans-Werner since I was an undergraduate student in Mannheim and took his class in public economics in 1981. I have been learning from him ever since and I am very grateful for the many opportunities I had to spend time at CES and CESifo.

I should also note that it is a challenge to speak about the European Monetary System with Hans-Werner in the audience. If I say something brilliant, chances are that he has already said it; and if he has not, I have reason to wonder why not. Nonetheless, I will comment on three issues, all relating to European public debt and deficits.

First, I will attempt a defense of the Maastricht rules. They are the original fiscal foundation of the Monetary Union, and they are sometimes ridiculed in the press. I will argue that they contain sensible ideas and were not too stringent.

Second, I will comment on the problem that triggered the European debt crisis: refinancing risk. I will argue that managing refinancing risk requires either a lender of last resort or drastic changes in debt policy.

My third comment is about the need to improve government accounting. A good starting point would be the adoption of corporate accounting principles, including consolidated government balance sheets and income statements.

Let me start with fiscal rules. The basic rules of the Maastricht treaty are well known: A debt-to-GDP ratio of no more than 60% and a budget deficit of no more than 3% of GDP. One serious objection to these rules is that they impose restrictions on the deficit with interest, whereas debt sustainability depends on the primary balance, which is the surplus or deficit excluding interest payments. It is worth explaining that the Maastricht rules are in fact systematic restrictions on the primary balance.

If one divides the 3% deficit limit by a 60% debt one obtains 0.05 or 5%. In a world

with moderate inflation, creditworthy governments should face nominal interest rates of about 5%; say, 2% inflation plus 3% real interest. This means that the Maastricht rules require a primary balance at about a 60% debt-GDP ratio. If debt is greater than 60% of GDP, the interest bill is greater than 3% and the government must run a primary surplus. If debt is less than 60% of GDP, the interest bill is less and the government can run a primary deficit. Either way, the greater the debt-GDP ratio, the greater is the required primary surplus.

It turns out that a positive relationship between debt-GDP ratio and primary surplus is exactly the requirement for debt sustainability that comes out of economic analysis. The formal statement that a fiscal reaction function with positive coefficient on the debt-GDP ratio is sufficient to satisfy the so-called intertemporal budget constraint, which guarantees that the debt is backed by the expected present value of future primary surpluses.

There is a special reason why I discuss debt sustainability in this symposium: Key parts of my research on the topic were done in Munich, when I was one of the first visitors at the Center for Economic Studies, the precursor of CESifo. If you are interested in the mathematics of debt-sustainability, CES working paper #3, dated 1991, is still a good reference.

I should note that the numbers for the required primary surpluses would change if interest rates were more or less than 5%. Higher primary surpluses would be required if interest rates are higher. But the principle remains the same: The Maastricht rules do not require primary surplus all the time, but greater debt-GDP ratios require higher primary surpluses – which makes sense.

More recently, political attention has shifted to debt-reduction rules. The Fiscal Compact requires a one-twentieth reduction in the debt-GDP ratio in excess of 60%. Such rules also impose a positive link between debt and primary deficits, but they are slightly different. Whereas

deficit rules specify debt-service efforts, debt-reduction rules specify the expected results. So see how similar they are, consider the 1/20 reduction specified in the Fiscal Compact: Since 60% divided by 20 is 3%, this gives countries in effect a deficit allowance of 3%, very similar to the Maastricht rule.

In summary, the Maastricht rules were quite well designed to ensure that fiscal policy would be fundamentally sustainable. It is regrettable that these rules were broken within just a few years, starting with exceptions for Germany and France.

Let me turn to refinancing risk, my second comment. We have all lived through the fiscal meltdowns in 2010 to 2012, when one country after another became unable to refinance maturing debt or, in case of Italy, had to pay unaffordable interest rates. The crisis was only stopped when Mario Draghi's gave his famous 'whatever it takes' speech in June 2012. At that point, the ECB had stepped in as lender of last resort. The question is: What went wrong?

The professional consensus seems to be that the contagion was due to excessive debt, excessive deficits, and that too much of the debt was short-term. I agree in principle, but I think many Europeans have illusions about how stringent the restrictions on debts and deficits would have been to eliminate the risk of debt runs. That's worth explaining.

The fundamental problem with refinancing is that it's a game between investors. Unless a government has the ability to pay off *all* of its maturing debt entirely out of current revenues, the refinancing game has a rational expectations equilibrium in which investors doubt the country's solvency and refuse to buy its debt. The refusal makes the country insolvent, so investor beliefs are confirmed. There are very few fiscal entities in the world that could pay all their maturing debts entirely out of current revenues – and none of the major developed countries would qualify.

Let's take Germany as example. At the end of 2014, almost 20 percent of public debt was maturing within 12 months, which is more than 11% of GDP. It's far fetched to think a country could suddenly run an 11% primary surplus. Germany would be insolvent without access to refinancing.

Why then is Germany considered a top-quality, triple-A rated borrower? One answer may be that everyone believes Germany is solvent and therefore buys German debt, which confirms the solvency. This is an equilibrium, but fragile, really no better than what Spain used to think. The second answer is that everyone believes, that if Germany were in trouble, the ECB would surely help. In other words, Germany is, and always was, too big to fail.

A comparison to the U.S. is useful because it illustrates the alternatives: The U.S. federal government issues short term

debt like European sovereigns and shamelessly relies on the Federal Reserve. The U.S. states live in a monetary union without access to a lender of last resort. While there is some fudging on the margins, in most US states, public debt is allowed only for identifiable voter-approved capital projects. Moreover, the debt consists of long-term bonds that are paid off over the lifetimes of the various projects.

This setup eliminates refinancing risk. If investors doubt a state government's solvency, new capital projects are stopped until confidence returns. That's inconvenient but does not trigger a financial crisis. The catch is that operating budgets must be balanced at all times. There is no deficit spending, and any counter-cyclical flexibility requires precautionary savings through rainy-day funds.

Moreover, this setup places bounds on the debt-GDP ratios that are much more restrictive than in Europe. On average, as of 2013, US state & local debt together is only 18% of state-GDP. State debt alone is only 7% of state-GDP.

To summarize my assessment: European governments have renounced central bank support by entering the monetary union. But they maintained the borrowing habits of sovereigns with their own fiat money. And this mismatched system did not work.

The US states went through a lot of fiscal turmoil and bankruptcies in the 19th century, until they adopted balanced budget rules; and it's not a perfect system – there are hidden liabilities that seem to be growing. I hope Europe will do better.

Regarding possible cures, I believe Europeans need to make up their minds: If ECB financing is categorically unacceptable – as many Germans seem to believe – then public debt should be vastly lower than it is, much lower than the 60% Maastricht limit. Even for Germany, going from 70% debt-GDP ratio to, say, 18% would not be easy.

Finally, let me comment on government accounting. This comment is motivated in large part by Hans-Werner Sinn's pioneering work on Target2 balances and by his analysis of the Greek bailouts.

Target2 exemplifies the problem. Politicians and European institutions are getting away with hidden transfers. The tricks are eventually discovered, and the discovery undermines public confidence in the European institutions. Similar problems arise when credit is channeled through special-purpose lenders that are kept off budget; when debts are rolled-over with interest despite their obvious unsustainability; or when debts are refinanced for long periods at below-market interest rates. We have seen all this in the Greek bailouts.

There is a straightforward cure for abusive government accounting: Governments should be required to follow standard corporate accounting principles. This includes a consolidated balances sheet that would tabulate not only the public debt, but also public assets and ownership stakes in special-purpose entities. A corporate-style income statement would show gains or losses on assets and on loans to other governments, in addition to the usual budget items. This would hold governments accountable for their stewardship of public funds.

The valuation of some assets and liabilities may be tricky, but corporate accounting provides many precedents for how one should account for unusual assets and for complicated contracts. Politicians tend to claim that their assets and liabilities are somehow special. But in most cases, they are not, and the claims of specialness are a way to escape accountability.

For example, take loans to Greece. If Germany extends a long-term loan at zero interest, it is clear that the present value of this loan is a lot less than the face value. So part of the loan disbursement is really a unilateral transfer that should be included as expenditure in the German budget – as part of the official accounting, not something that requires forensic research by economists. As it is, Germany keeps hides cost and understates the German budget deficit.

To be clear, I am not against fiscal transfers across countries. European countries are almost all welfare states with progressive tax systems. If such countries form a union, the principles of progressive taxation will invariably apply to that union. This means relatively rich states like Germany will have to transfer some percentage of their GDP to poorer members – most likely forever, and similar to how countries deal with internal income inequality. The only question is how much is transferred and in what form. Negotiations about government bailouts are essentially about the ‘how much’ question. Unfortunately, subsidized loans are an inefficient and cumbersome form of fiscal transfers. They also tend to involve monetary institutions that do not have political legitimacy as fiscal agents.

In summary, government accounting is still in the dark ages, prior to the invention of balance sheets and income statements. I believe a cleanup of government accounting would do much to improve confidence in the European Union and in the European Monetary System.

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Prof. Dr. Dr. h.c. mult. Otmar Issing  
President Center for Financial  
Studies, University of Frankfurt

It is a privilege to contribute to this conference in honor of Hans-Werner. I have known him since the start of his remarkable academic career in Mannheim and was already impressed by his presentation at my seminar in Würzburg. Hans-Werner is both – an outstanding researcher and an eloquent public representative of sound economic thinking – for a long time a very rare combination in Germany. If my memory is correct his wife once rightly called him a »missionary«.

In this capacity he has contributed to all major economic debates in DE – and mostly dominated the discussion. This is especially true for all the problems related to European integration. This topic should of course not be missed at this conference.

Let me concentrate my short remarks on the relation between monetary union and political union in Europe. In this context it is worth remembering that after WW II European integration started as a political project. The construction of the European Coal and Steel community shows clear evidence for the priority of politics. However, this political approach failed when in the summer of 1954 the French National Assembly did not ratify the treaty of a European Defense Community. European integration thereafter concentrated on economics culminating in the single market.

Why did political integration fail and economic integration succeed? Economic integration is a kind of »functional« approach. It started with reducing intra area tariffs and continued by removing step by step all barriers on economic ac-

tivities between member countries. Stronger trade relations and a more competitive environment would bring welfare gains for all members. The implicit loss of national sovereignty was limited to the field of economic activities by creating an equal level playing field. The core of national sovereignty like public finance was not touched by these developments. The success of this approach combined with limited intrusion into national political sovereignty attracted first other Western European countries like the UK and later after the fall of the iron curtain a large number of former communist countries.

### EMU – a Watershed

The Single Market guarantees the »four freedoms«, the free movement of goods and services, capital and last not least people. With the removal of all barriers – a still not fully accomplished project – this kind of functional integration reaches its peak. Sharing a common currency eliminates the exchange rate risk for intra-area transactions and in so far completes the single market. This marks so to say the end of the contribution of economics to integration. And it is the other side of the introduction of the common currency which brings further integration via institutional change. Establishing a common central bank represents an element of statehood, and transferring competence to the European level is a sign of giving up national sovereignty in such a fundamental field as monetary (and exchange rate) policy.

However, this kind of implicit political integration is not what leading politicians primarily had in mind when they discussed the concept of EMU. Their ambition went much further in the direction of a political union on its own rights. As former German chancellor Kohl made fully clear when he addressed the German Federal Parliament on November 6, 1991: »It cannot be repeated often enough: Political union is the indispensable counterpart to economic and monetary union. Recent history, and not just that of Germany, teaches us that the idea of sustaining an economic and monetary union over time without political union is a fallacy.«

In the meantime there is a strange line of argument connecting monetary union and political union. On the one hand we have the notion that a common currency should work as a pacemaker towards political union. The shortest version of this view is Jacques Rueff's dictum from 1950: »L'Europe se fera pas la monnaie, ou ne se fera pas«. This idea was revived in the context of the introduction of the euro (Issing 2008). As the optimism that the euro would strengthen identification of people with »Europe« has been bitterly disappointed – the opposite seems to have happened – the argument is now turned upside down: steps in the direction of political union have to be taken to prevent a collapse of the euro area.



These are proposals without any consideration on the preferences of the people in Europe. In the beginning European integration was a project driven by exceptional personalities, and this »from above approach« continues until today. Habermas (2008) e.g. deplores this »elitist approach« and requests support from the people. However, which politician would dare to ask for a referendum in member-countries for a support on the project of political union? This has in all likelihood been an »elitist illusion« for long, but in the context of recent developments – take only the refugee problem – such an approach is just unrealistic.

If the political union remains at best a vision for the distant future all proposals implying moves in this direction not only have lost their anchor, but will magnify the risk of bringing up governments and the people even more against each other. As a consequence such proposals increase also the risk that even the status quo is in danger.

It is high time to reconsider what EMU at present still is – and will remain for the unforeseeable future, namely a union of in principle sovereign states which share a number of common institutions, but will not abandon their full sovereignty on fiscal policy. This conclusion leads back to the perception that EMU is based on treaties which have to be respected again, and responsibility for national policies have to be taken by national states. To refer to a major element of the treaty, the no-bail-out-clause should be sufficient to demonstrate how urgent and challenging this task is.

I would like to conclude with a quote from Hans-Werner's recent book:

»The better Europeans are not the romantics, but those who seek realistic solutions that accord with the free will of the people, the law of economics, and the free decisions of parliaments, without the latter being predetermined by technocratic bodies overstressing their mandate, and solutions that can be applied without a forced redistribution of wealth.«



Prof. Dr. Frank Westermann  
Professor of Economics, University  
of Osnabrück

### Balance of Payments Deficits

Thank you very much. A lot has been said about *Public Deficits* already, and in my statement, I would therefore like to focus instead on *Balance of Payments Deficits*.

It is now almost exactly 5 years ago that Hans-Werner Sinn has pointed out the existence of a balance of payments crisis in the Euro Area – an aspect of the crisis that had been unnoticed even by those observers who have been following the current events very closely.

In emerging market economies, of course, such a BoP crisis could not have lasted for very long. In order to sustain a balance of payments deficit, countries in Latin America and Asia had to run down their reserves at the central bank. And when these reserves fell to a critically low level, a speculative attack set in, breaking the fixed exchange rate regime apart.

In the Euro Area, by contrast, countries in crisis did not run down their reserves. Also the Euro did not break apart. Instead, they have accumulated intra-Euro-system liabilities against the ECB, called TARGET2 balances.

### The Data

Hans-Werner Sinn and Timo Wollmershäuser were the first to construct a data set on TARGET balances, using the IMF's international financial statistics. At the Institute of Empirical Economic Research at Osnabrück University, we also main-

tained a data base, assembled from the monthly reports of national central banks. Only a few month ago, in September 2015, the ECB officially released these data, in the statistical warehouse on their web-page.

It shows that presently, the debtor countries have total liabilities of 720bn Euro. This is a very large amount. It is about twice the federal budget of Germany, and it is larger than any other rescue institution.

The initial debate on Target2 balances had focused in the question whether TARGET-system had primarily been used to finance the current account, or whether it had been used for outright capital flight. In my view, this is not a very interesting aspect of the debate.

### The Welfare Question

The much more important question is whether the reaction of Euro-system, which was tolerating large TARGET2 imbalances, has been an appropriate or even optimal response from an aggregate Euro-Area welfare point of view.

Some would argue that this has been the case, as the financial lifeline it provided had acted as something like an automatic monetary stabilizer. It certainly has prevented the sharp adjustment that typically follows a »Sudden Stop« in financial flows.

In my opinion, however, it has not been optimal response, and I would like to give three different reasons for this.

1. The first one comes from looking at economic history. In 1994, Mexico had experienced the first modern-type balance of payments crisis. In an influential article, Jeffrey Sachs, Aaron Tornell and Andres Velasco have shown that the monetary expansion and parallel running down international reserves, before the fix-exchange rate regime broke up, in retrospect has been very damaging for taxpayers in Mexico. They have lost their national wealth at the central bank, while international investors pulled out their money. The article was published in *Economic Policy*, a Journal Hans-Werner knows very well, as he has been the editor for more than 20 years. A subtle difference of course is that in Europe, central banks can place the burden also on other countries tax-payers, not just their own.
2. The second argument is that the liabilities in the TARGET2 system may not be transitory. There is a long literature on windfalls in economics. I only would like to refer to an Article Hans-Werner and I had written on *transfer economies*, called the »Two Mezzigiornos«. We were comparing the east-and west of Germany to the north and south of Italy. In these countries a continuous

stream of transfers had caused a situation similar to the »Dutch disease«, and in my view there is a real risk, that we will see a similar process in the crisis countries of Europe.

3. Finally, and most importantly, I see a *tragedy of the commons* in the institutional setup of the Euro-system. A tragedy of the commons arises, when policy makers compare the marginal benefit to the average cost of a policy decision. In my view, this is the case, when monetary policy is decided up in Frankfurt, but is implemented by 19 different national central banks. Let us consider the decision problem of a national central bank that is deciding on whether or not to provide further refinancing credit to a banking institution that is on the brink of insolvency – to a troubled bank in their jurisdiction. They compare *marginal benefit* of providing of this decision to the average cost: The marginal benefit is to protect national tax payers from the cost of bank resolution. The *average costs* are the potential credit write-downs in case of insolvency that would be shared with the ECBs capital key, or the inflation that would spread across countries in an integrated economy. The way this decision problem is phrased creates an expansionary bias: it creates an overwhelming incentive to classify a bank as solved, accept low quality collateral and provide further loans by the national central banks. The increase in TARGET2 liabilities is a direct consequence of this decision.

### The Cures

These are the deficits, but let me also talk about the cures. The introduction of a common supervisory framework has been a big step in the right direction. However, not only the largest banks, but also the smaller ones should be supervised. Also an independent agency would be better suited than the ECB and common collateral standards need to be re-introduced.

Alternatively, the European Economic Advisory Group at CE-Sifo, EEAG, has proposed a periodic settlement in assets or gold, or senior tax claims.

To give a fair account of this topic one needs to acknowledge that so far, we have not seen any credit write-down, nor has the monetary expansion lead to inflation. But certainly both may still come in the future! I would like to conclude my statement by citing Rudi Dornbush on this topic.

### The Outlook

In 1999, Rudi Dornbush had given the Munich Lectures in Economic and was named the CES distinguished fellow this

is very room, the Große Aula of the University of Munich. For me, it was my first year at CES and the lecture was a really memorable experience.

From today's perspective, it is interesting, because in his discussion, Dornbusch had commented on the difference between balance of payments crises in emerging markets like Latin America and Asia, and a balance of payments crisis in Europe or Germany. Unfortunately he has not able write up the MIT Press book, as he died shortly after. But Hans-Werner Sinn and Stanley Fischer initiated a transcript of this lecture and circulated it as a CESifo working paper.

In this paper, Rudi Dornbusch says that Balance of Payments crisis in Emerging Markets and high income countries are nearly the same. The only difference is – and here I would like to literally quote – that »A very rich country, can do very bad things, for VERY VERY long.«

Thank you for your attention.

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