Europe’s Brush with Debt

MUNICH – French Prime Minister Manuel Valls and his Italian counterpart, Matteo Renzi, have declared – or at least insinuated – that they will not comply with the fiscal compact to which all of the eurozone’s member countries agreed in 2012; instead, they intend to run up fresh debts. Their stance highlights a fundamental flaw in the structure of the European Monetary Union – one that Europe’s leaders must recognize and address before it is too late.

The fiscal compact – formally the Treaty on Stability, Coordination, and Governance in the Economic and Monetary Union – was the quid pro quo for Germany to approve the European Stability Mechanism (ESM), which was essentially a collective bailout package. The compact sets a strict ceiling for a country’s structural budget deficit and stipulates that public-debt ratios in excess of 60% of GDP must be reduced yearly by one-twentieth of the difference between the current ratio and the target.

Yet France’s debt/GDP ratio will rise to 96% by the end of this year, from 91% in 2012, while Italy’s will reach 135%, up from 127% in 2012. The effective renunciation of the fiscal compact by Valls and Renzi suggests that these ratios will rise even further in the coming years.

In this context, eurozone leaders must ask themselves tough questions about the sustainability of the current system for managing debt in the EMU. They should begin
by considering the two possible models for ensuring stability and debt sustainability in a monetary union: the mutualization model and the liability model.

Europe has so far stuck to the mutualization model, in which individual states’ debts are underwritten by a common central bank or fiscal bailout system, ensuring security for investors and largely eliminating interest-rate spreads among countries, regardless of their level of indebtedness. In order to prevent the artificial reduction of interest rates from encouraging countries to borrow excessively, political debt brakes are instituted.

In the eurozone, mutualization was realized through generous ESM bailouts and some €1 trillion ($1.27 trillion) worth of TARGET2 credit from national printing presses for the crisis-stricken countries. Moreover, the European Central Bank pledged to protect these countries from default free of charge through its “outright monetary transactions” (OMT) scheme – that is, by promising to purchase their sovereign debt on secondary markets – which functions roughly as Eurobonds would. The supposed hardening of the debt ceiling in 2012 adhered to this model.

The alternative – the liability model – requires that each state take responsibility for its own debts, with its creditors bearing the costs of a default. Faced with that risk, creditors demand higher interest rates from the outset or refuse to grant additional credit, thereby imposing a measure of discipline on debtors.

The best example of the liability model is the United States. When US states like California, Illinois, or Minnesota get into fiscal trouble, no one expects the other states or the federal government to bail them out, let alone that the Federal Reserve will guarantee or purchase their bonds.

Indeed, the Fed, unlike the ECB, does not buy any bonds from individual states; investors must bear the costs of any state insolvency. In 1975, New York had to pledge its future tax revenues to its creditors in order to remain solvent.

Of course, the US was not always so strict. Shortly after its founding, it tried debt mutualization, with Alexander Hamilton, America’s first Treasury secretary, describing the scheme in 1791 as the “cement” for a new American federation.

But, as it turned out, the mutualization model – used again in 1813 during the second war against the British – fueled a credit bubble, which collapsed in 1837 and thrust nine of the 29 US states and territories into bankruptcy. The unresolved debt problem exacerbated tensions over the slavery issue, which triggered the Civil War in 1861.
In this sense, as the historian Harold James has noted, mutualization turned out to be dynamite, not cement, for the new US federation. Only after the Civil War did the US decide to operate the federation according to the liability model – an approach that has underpinned stability and limited individual states’ debt levels ever since.

For Europe’s leaders, the withdrawal by France and Italy from the fiscal compact should serve as a clear sign that the mutualization model is not working for the eurozone, either. Following the Fed’s example, the ECB should abolish its OMT program – which, according to Germany’s Constitutional Court, does not comply with EU treaty law anyway.

Furthermore, the ECB should reintroduce the requirement that TARGET2 debts be repaid with gold, as occurred in the US before 1975 to settle balances among the districts of the Federal Reserve System. Perhaps even the fiscal compact itself should be reconsidered.

Such measures would serve notice to investors that they cannot hope to be saved by the printing press in times of crisis, and would thus compel them to demand higher interest rates or deter them from granting credit in the first place. This would lead to greater discipline among the eurozone’s indebted countries and save Europe from a debt avalanche that could ultimately drive currently solvent states into bankruptcy and destroy the European integration project.

https://www.project-syndicate.org/commentary/eurozone-debt-mutualization-or-individual-liability-by-hans-werner-sinn-2014-10

© 1995-2014 Project Syndicate