

Summary

The financial crisis has revealed how susceptible many European member states' finances were to a severe recession. Portugal, Ireland, Italy, Spain and Greece are struggling with extremely large budget deficits, an increase in the cost of servicing their debts, and mounting debt stocks. At the start of 2009, there were fears that a eurozone country might default, which could cause contagious increases in the cost of servicing debt elsewhere and further financial turmoil.

The European Union's Stability and Growth Pact (SGP) was supposed to encourage governments to run budgets close to balance over the economic cycle. Since the launch of the euro, the EU's governments have become increasingly ill disciplined, however, which has negative consequences for the eurozone as a whole. The Commission was given the job of policing the pact by recommending sanctions to the European Council, but it has rarely applied them. Thus, transgressors usually avoided punishment.

This paper proposes a new system, by which an incentive would replace an extremely blunt stick. Several economists and policymakers have suggested that the eurozone should promptly create a common bond system to help countries that are currently struggling with their debts gain access to cheaper financing. This paper suggests a medium term solution instead: the common bond system should be linked to the Stability and Growth Pact. Governments would be able to issue debt through the system only once their debt to GDP ratio has started to fall. This would encourage governments to consolidate once the recession is over; help to prevent high government debts in some countries causing problems for others; and make it less likely that a highly indebted government will have to be bailed out to save the European economy in the future.

Strengthening the Stability and Growth Pact with a common eurozone bond

August 2009

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CENTRE:FORUM

Introduction

The European Union's response to the financial crisis has been ad hoc and poorly co-ordinated at best. National governments have rescued their own financial systems, without thinking about the impact of their actions on other member states' economies, or on the single market. They have also been unwilling to share resources to fight the crisis. There is currently little appetite for any form of burden sharing when rescuing cross-border banks. Governments prefer instead to break them up along national borders so that they do not have to agree upon a common insolvency procedure, or share the cost of recapitalisation.

This is also true of the fiscal costs of the recession. France and Germany, alongside the European Central

Bank (ECB), have made clear that governments in the eurozone need to deal with the fiscal costs of the recession by themselves, stressing the 'no bail out clause' in the Maastricht Treaty, which bans nations from bearing the debts of others. Furthermore, Germany's constitutional court barred any fiscal co-operation between Germany and other EU governments in July 2009.¹

In this context, it is not surprising that Germany and the European Central Bank have ruled out the creation of a common European bond for eurozone members. The bond has been suggested as a means of helping countries that are struggling with their debts, as some EU member states were better able to cope with the fiscal costs of the crisis than others.² France and Germany have large economies and large tax bases, and have been able to take on extra debt without being hampered by unaffordable yields. They benefited from a 'flight to safety', as investors moved into the least risky government debt – and a 'flight to liquidity', as investors sought assets that they could readily convert into cash. Portugal, Ireland and Greece, on the other hand, have seen sharp rises in the cost of debt, raising the possibility that Germany and France might unilaterally have to bail out a country that could not service its debts. Thus, a common bond was proposed as a means of reducing their debt costs – by issuing at least some of their debt together, eurozone countries would pay lower interest rates to investors, and a larger, more liquid and deep market would potentially reduce long term interest rates across the eurozone economy, and develop the euro as a reserve currency.³

Germany has always been worried that fiscal profligacy by other member states would undermine eurozone competitiveness, drive up inflation and interest rates, and heighten the risk that a highly indebted member state would have to be bailed out. In March 2009,

Some countries have seen sharp rises in the cost of their debts, raising the possibility that Germany might unilaterally have to bail out a country in trouble

German and French finance ministers called on governments to adhere to the fiscal rules of the Stability and Growth Pact. And Germany and the ECB worry about 'moral hazard' – the fear that if the EU were to bail out troubled countries it could encourage governments to continue with irresponsible budget deficits and levels of debt.

While Germany is right to be concerned about high government debts in the eurozone, it is not enough to call for a return to the old fiscal rules. Eurozone governments frequently broke the rules even in periods of economic growth, and there is little reason to believe that calling for governments to stick to the rules will have much effect. It failed because the available sanctions – naming and shaming by the Commission, followed by fines by the Council – were rarely employed.

The economist Richard Posner has argued that laws – or in our case, rules – should act on the 'economic assumption that individuals [or states] are rational maximisers', and thus the role of law is to 'change the relative prices attached to alternative individual actions'.⁴ Under the current SGP, there are few costs (other than a damaged reputation) and therefore the price of transgression is too low.

A common bond system could make it more expensive to break the pact. This paper proposes a new system of fiscal rules for the eurozone, by which a common debt system could underpin the SGP. Governments would only be able to issue debt through the system once they have stabilised their debt ratio through spending cuts and/or tax rises. This system would provide cheaper financing for governments

1 The Economist, 'Those selfish Germans', April 15 2009; W Münchau, 'Berlin has dealt a blow to European unity', Financial Times, July 12 2009.

2 D Gros and S Micossi, 'A bond-issuing EU stability fund could rescue Europe', Europe's World, Spring 2009; W Münchau, 'The benefits of a single European bond', Financial Times, January 25 2009.

3 SIFMA, 'A common European government bond', January 2009.

4 R Posner, 'Law and Economics', 1997.

The Stability and Growth Pact has been frequently broken, even in periods of economic growth, and there is little reason to believe that calling for governments to stick to the rules will have much effect

after future downturns; strengthen the euro as a reserve currency; and encourage governments to consolidate after a recession, which would diminish inflation pressures and keep interest rates lower across the eurozone in the medium term.

Combining the SGP and common debt would also balance member states' competing interests. While Germany abjures 'fiscal federalism', it is keen for member states to quickly pay down government debt to make eurozone interest rates lower in the long term. And while a debt-rules combination would not help heavily indebted countries like Greece and Portugal immediately, it would provide better access to credit and cheaper debt servicing in the future, if they tighten their fiscal policies. Thus it would provide a compromise, by which all benefit.

In Section I, this paper provides a brief overview of the state of eurozone government finances, and explains why the SGP is unlikely to motivate swift fiscal consolidation by eurozone member states once the economy recovers. Section II explains how the common bond could be built in to the Stability and Growth Pact, and provides detail on how the common debt instrument would work, how it would be introduced, and how Germany and France – the countries most likely to oppose the scheme – could be assured that they will not have to pay higher yields on their debts. Section III shows how countries in central and eastern Europe, once they have turned their economies around and fulfilled the criteria of ERM-II for eurozone entry, could be encouraged to maintain a tight fiscal policy, which the original ten members failed to do after 1999.

1. The rules don't work

Voters and markets should encourage nation states to keep debts under control.⁵ Excessive public debt pushes up interest rates, and heightens the risk of either outright default or inflation as a way of reducing the burden. Before the launch of the euro, these risks were largely a matter for individual states. If a country's policies were unsustainable, then its own borrowing rates and currency would be weakened without negative consequences for the rest of the EU.

The creation of the euro has changed this. When several countries use the same currency, the consequences of unsustainable fiscal deficits spill across borders. A large increase in debt in one country raises interest rates and the risk of inflation across the eurozone. Furthermore, a member running an unsustainable deficit will not suffer exchange rate volatility. Because the consequences of irresponsibility are shared – and to a degree diluted for the offending country – the market incentives to behave prudently are weakened.

These risks were well understood when European Monetary Union was first proposed. In an effort to limit them, the SGP required that members of the eurozone stick to explicit fiscal rules. The principle rules are:

- the annual deficit must be kept below 3 per cent of GDP
- over the medium term the budgetary position of each member of the eurozone should be 'close to balance or in surplus'
- overall public debt must not be larger than 60 per cent of GDP.

Under the rules, the EU can employ sanctions against member state governments that breach these limits except when they are suffering from a recession or a prolonged period of very low growth. Clearly, the financial crisis and ensuing recession fulfil both these criteria. The IMF forecasts that 13 of the 15 eurozone countries will break

⁵ A Murray and G Wilkes, 'Fiscal Rules OK?', January 2009.

Table 1. Eurozone budget deficits (% of GDP)

	2007	2008	2009	2010
Austria	-0.5	-0.4	-3.5	-4.2
Belgium	-0.3	-1.2	-4.7	-5.6
Cyprus	3.4	1.0	-1.0	-1.8
Finland	5.2	4.1	-1.6	-3.4
France	-2.7	-3.4	-6.2	-6.5
Germany	-0.5	-0.1	-4.7	-6.1
Greece	-3.5	-3.7	-4.5	-5.2
Ireland	0.2	-6.4	-14.2	-17.2
Italy	-1.5	-2.7	-5.4	-5.9
Luxembourg	3.2	1.4	-3.4	-4.4
Malta	-1.8	-4.1	-3.6	-2.5
Netherlands	0.3	0.8	-3.2	-4.0
Portugal	-2.6	-2.6	-5.9	-6.1
Slovak Republic	-1.9	-2.2	-2.9	-2.9
Slovenia	0.3	-0.3	-4.2	-3.7
Spain	2.2	-3.8	-7.5	-7.5

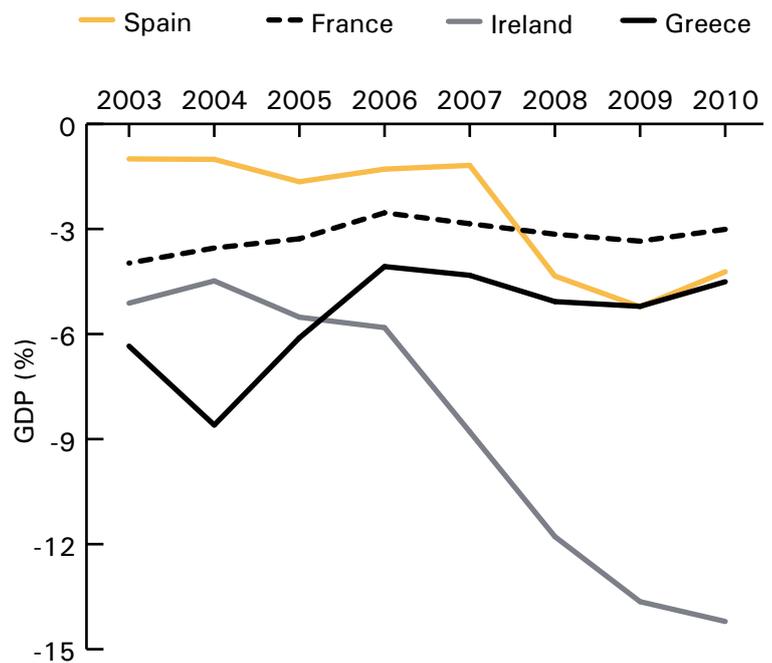
Source: IMF

the 3 per cent ceiling by 2010 (see Table 1).

Rising debt will hamper the eurozone's recovery, putting upward pressure on the region's interest rates, potentially crowding out private sector lending, which is still weak. High government debts may cause the euro to appreciate, as overseas investment flows in to pay for deficits.

Almost all eurozone economies will shrink in 2009. However, it is now apparent that many countries went into the recession with a structural deficit, so politicians cannot solely blame the state of their public finances on a severe cyclical downturn. The worst offenders are Ireland, Italy, Portugal, Greece and Spain, who have either been running structural deficits of more than 3 per cent of GDP for many years or have a large stock of debt to deal with – or in the case of Spain and Ireland, have seen revenues collapse as the property bubble burst (see Chart 1).⁶ Ireland's budget deficit is likely to reach 17.2 per cent of GDP in 2010. Belgium, Greece and Italy all now have total debts that exceed 90 per cent of GDP.

Chart 1: Eurozone structural deficits



Source: IMF

Governments in the eurozone should pursue fiscal consolidation as Europe's economy starts to recover. Some, like Ireland, have already started to make deep cuts. Others, like Greece, are gambling on a fiscal stimulus financed by a sharp turnaround. Greece is increasing spending by 8 per cent, with a 10 per cent wage hike in public sector wages and pensions, which is hardly the sort of elastic, easily drawn down stimulus that is likely to return a budget to balance.⁷

It is unlikely, however, that the SGP by itself will provide much motivation for governments to tighten their fiscal policies and pay down debts once recovery is underway.

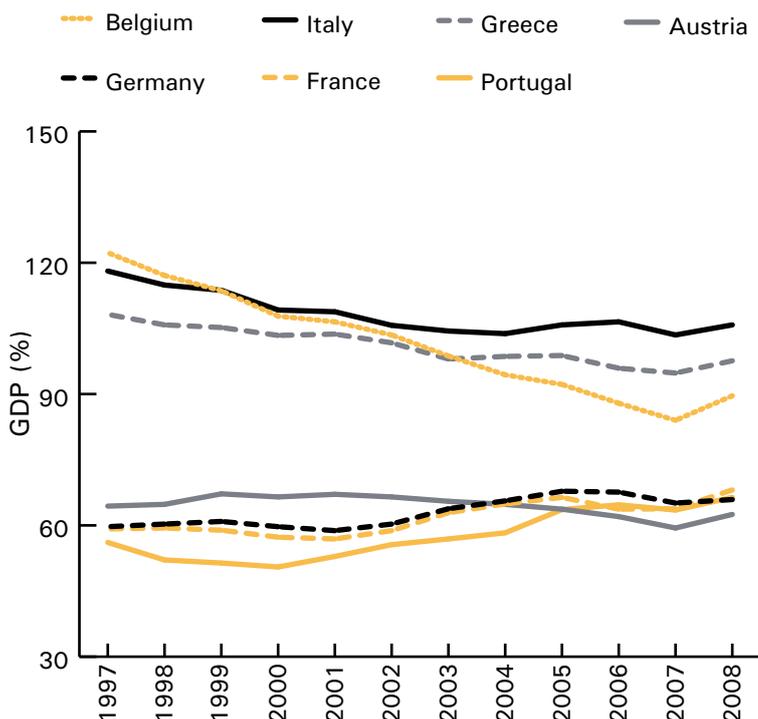
In the past decade, countries have frequently broken the rules without sanction. As is often the problem with fiscal rules, there has been too little 'stick', because national governments change them when they are no longer politically useful.⁸ The pact relied on a weak Commission enforcing sanctions against powerful member states. Under the terms of the pact, countries are first investigated by the Commission, then publicly warned, and then fined by the Council if suitable budgetary

6 The Economist, 'Holding together', 13 June 2009.

7 Oxford Analytica, 'Greece: 2009 Budget too good to be true?', 7 January 2009.

8 A Murray and G Wilkes, 'Fiscal Rules OK?', CentreForum, January 2009.

Chart 2: Gross debts



Source: Eurostat

retrenchment policies are not put in place. In 2002, the Council started sanctions proceedings against Portugal, warning Lisbon to take steps to adjust the budget deficit. But the EU did not impose a fine after Portugal drew up plans to return to a point below 3 per cent of GDP after 2004.

The rules have also become less effective over time. When they were first established, governments frequently attacked the rules for being too inflexible. When France and Germany also broke the 3 per cent rule in 2003, they persuaded the Council not to impose sanctions as a sharp fiscal consolidation would damage growth, which was stagnant at the time. Fearing future sanctions themselves, finance ministers had little incentive to support Commission calls for tougher action.⁹ France and Germany also persuaded the Council to relax the terms of the pact. From then on, no excessive deficit procedure would be launched if a member state was experiencing negative growth at all (before, it was a sharp downturn of more than 2 per cent of GDP) or even long periods of low growth. Countries

would also avoid sanctions if they could show that their excessive deficit was 'temporary', and were allowed to point to forecasts of potential growth, the economic cycle, and the impact of structural reforms as evidence.

By making the rules more flexible, the EU made them less transparent, as member states could present hopeful forecasts. Moreover, once France and Germany had avoided sanctions it became impossible to employ them against others. Italy's budget deficit rose to 4.3 per cent of GDP in 2005, and its level of debt topped 100 per cent of GDP. By laying out a reform programme, and citing the Council's failure to warn France and Germany over their breaches of the pact, Italy avoided any sanctions from the Council.¹⁰

Without an incentive to reduce budget deficits, the pact fails to encourage governments to run surpluses during cyclical upswings in order to save for the downturn. A recent study has confirmed that eurozone countries have persistently failed to deliver on the budget plans agreed with the European Commission. In 2000, for example, the eurozone enjoyed a 3.4 per cent growth rate, and rising oil prices raised inflationary pressures – but France, Germany and Italy failed to fiscally consolidate to the degree that they had planned.¹¹ As Chart 2 shows, France, Germany, Austria and Portugal have all had rising debts during the years of economic growth since 2003, and were breaking the 60 per cent ceiling before the current recession got underway. Meanwhile Italy, Greece and Belgium all paid down their debt, but were still breaking the rule by some distance.

The SGP is therefore unlikely to bring about the necessary fiscal tightening in the eurozone.

Markets too may not police governments effectively once the European economy starts to grow again. At present, investors are demanding a premium from countries with unsustainable finances. For some countries, the cost of servicing their debts has risen

9 C Wyplosz, 'Fiscal policy: institutions vs rules', 2005; M Feldstein, 'The euro and the stability pact', 2005.

10 Euractiv, 'Italy given until 2007 to correct its excessive deficit', June 29 2005.

11 M Buti et al, 'Revisiting the Stability and Growth Pact: grand design or internal adjustment?', 2002.

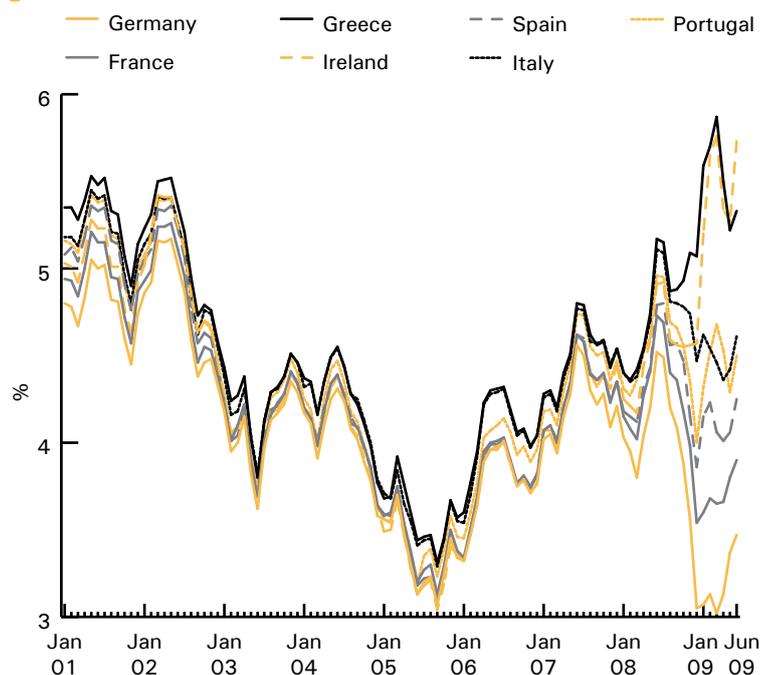
dramatically since the onset of the credit crunch (see Chart 3). But for others, a 'flight to quality' has reduced borrowing terms. During times of financial stress, investors rush to place their money where they think it is safest and most easily accessed, favouring deeper and more liquid markets.

Investors are demanding higher yields on Irish and Greek bonds for several reasons. They think these countries are more likely to default on their debts, because their revenues have collapsed and, by propping up their financial systems, they are greatly increasing their financial obligations. But investors also sought liquid assets as the credit crunch struck. Leuven University economists Paul De Grauwe and Wim Moesen take this view, calling the rising spreads on bonds in Portugal, Ireland, Italy, Greece and Spain over German bonds evidence of a 'flight to liquidity'.¹²

Markets usually provide signals that a country's policies are not sustainable. But the evidence of the past decade suggests that they too can fail to provide signals in a timely or unambiguous way. The spreads between Greek and German bonds were so low as to provide virtually no incentive for the Greek government to pursue a tight fiscal policy. Now the encouragement offered by the market is very strong, but too late, and may even be forcing some embattled governments to consolidate at the very worst time – tightening policy during the downturn.

In sum, since the advent of monetary union, neither institutional rules nor market pressure have worked to prevent some governments from passing on the costs of their loose fiscal policies onto the eurozone as a whole.

Chart 3: Rising spreads on ten year government bonds



Source: European Central Bank

2. A common eurozone bond

There will be no easy solution to the large debts being incurred during the current recession. A long period of fiscal consolidation will be needed once the eurozone is growing again: it may take up to ten years before government debt ratios are generally stable. In the meantime, there is a risk that market fears about the sustainability of government finances will drive up interest rates, or increase the risk of inflation once recovery is underway.

Eurozone governments should act now to create a system which is based upon incentives, rather than rules – which have proved too easy to break. Governments should agree to issue debt jointly in a common instrument, which would give countries like Ireland, Greece and Portugal access to a larger and cheaper debt market. However, countries should be given access to the common debt instrument only when they have created large enough budget surpluses to make their debt to GDP ratio start to decline. If member states act now and agree to the system, those countries that are struggling with their finances will be given an incentive to reduce their debts and return to balance once recovery starts. Over the next economic cycle, eurozone

12 P De Grauwe and W Moesen, 'Gains for all: a proposal for a common Euro bond', May/June 2009.

government finances will remain closer to balance, as governments will have an incentive to consolidate during an upswing. A bond-rules combination would also allow governments to expand their balance sheets to stabilise their economies in the next recession – but will have to pay for it through their own national debt.

The details of the scheme are laid out below. First, we explain how the common instrument would create a larger, more liquid, and therefore cheaper debt market. Second, we explain how the common debt should be linked to a new Stability and Growth Pact. Third, to bring France and Germany on board, we show how the debt system should be designed so that they do not suffer higher interest rates on their debts.

A common debt market will be more liquid, and would strengthen the euro

A common bond would reduce the cost of borrowing and improve eurozone credit markets in three ways. First, the larger the volume of trade in a particular bond, the more liquid the market is. The current decentralised system, by which eurozone member states issue their own debt, is relatively illiquid, especially for smaller countries. The small market for Greek debt means that investors demand a higher yield, because it is not as easy to sell as German or French debt. So, by expanding the market for eurozone government borrowing, which is currently fractured into national providers, the yield investors' demand would be lower, because the liquidity costs would be lower too.

Second, the market would also be deeper. Investors in international bonds want to be able to move large amounts of cash into bonds and back out again without altering the price – government bonds become a useful alternative for large investments only if this is the case. The more bonds that are traded, the deeper and more liquid the market becomes.

Finally, the development of a large single market for short term eurozone bills would also create a large futures market, which would further boost demand for eurozone debt, creating a virtuous cycle. Futures contracts are used to hedge interest rate risk. These contracts are based upon hedging

A common bond would reduce the cost of borrowing and improve eurozone credit markets

investments in short term bills, and if there was a euro-area common bill, the market would be larger and more efficient. Similarly, it would improve the market for repurchase agreements, known as repos. Highly liquid short term government bills provide the perfect vehicle for these money market transfers, because they provide a good store of value, and a 'benchmark' for the formation of a no-risk interest rate.¹³

A common bond would also help to develop the euro as a global reserve currency: governments outside the eurozone may hold the common bonds or bills in order to manage their own exchange rates, if they are on a pegged system.¹⁴ Some commodities may be marginally cheaper, as they would be priced in euros.

All member states would benefit from these developments, as would the wider economy as interest rates fell.

A Stability and Growth Bond

At present, with the financial markets fragile and economic recovery still uncertain, it is difficult to predict where eurozone debt levels will stand once the recession is over.

However, it is possible to outline some rules of participation in the common debt system which would provide an incentive for governments to fiscally consolidate in the next period of economic growth. It is important that the entry requirements are not so strict that no government will use the common system, nor so loose that governments overload the system with debt, driving up yields.

13 Bank of International Settlements Quarterly Review, 'The emergence of benchmark yield curves', December 2001.

14 SIFMA, 'A common European government bond', January 2009.

This system of rules, underpinned by a common debt instrument, would provide a more effective incentive to balance the budget over the economic cycle than the current system, which relies on a weak Commission naming and shaming more powerful member states

To be able to issue debt, participants must have a declining debt to GDP ratio. In their paper promoting a common T-bill, the Securities Industry and Financial Markets Association recommended that the maximum participation should then be capped at 20 per cent of GDP.¹⁵ But it would be preferable if this level was determined by the size of a country's structural deficit. For example, a country with a deficit of 4 per cent of GDP should be allowed to issue up to 5 per cent of GDP through the system, whereas a country with no structural deficit could issue up to 20 per cent of GDP. To avoid national governments accounting tricks, the Commission should be in charge of determining the size of each country's structural deficit.

We recommend that the common system should start by issuing a common T-bill – debt with a term of less than one year. This would be easiest to introduce, because member states' short term debt could be rolled over into the common system quickly. The yield spreads between Greece and Germany's short term debt are also much lower than for longer term bonds, which would make it less likely that Germany might pay more on their debts. Bonds could be phased in later, once the market for bills had developed.

By starting with short dated T-bills, governments would be less likely to break the fiscal rules or default on

their debt. If they did, they would be ejected from the system, and because the debt is short term, they would see their borrowing terms deteriorate within a few months. Moreover, the cost to the other countries of having to borrow jointly with the offending country would be removed – within a year, they would no longer be in the position of having to borrow alongside the fiscally profligate country. Finally, the majority of any country's debts are likely to remain in their own name, and the market will therefore continue to exercise discipline as before. Taken together, these conditions ought to greatly diminish moral hazard.

The debt should be managed by a new arm of the Commission. It should be independent of national governments and the ECB, so that investors can be confident that the ceilings for entry to the system will be strictly enforced, and that the ECB will not be tempted to inflate debt away. The Commission, which has stuck closely to its mandate when policing the SGP, would be unlikely to cave in to pressure from member states' finance ministers; it was the arrangement whereby finance ministers on the Ecofin committee had to agree to sanctions that rendered the pact unworkable.

Over time, once the T-bill market had grown and once governments had built up trust with investors by sticking to the fiscal rules, bonds of longer duration could be issued. National governments issue much more debt through bonds than bills, because it allows them to borrow over long periods at lower cost, and to finance long term projects which will only accrue revenue in the future. Consequently, the market for bonds is much larger: eurozone governments issued €4,594 billion in bonds, compared with €622 billion in T-bills in 2008.¹⁶ A common bond with lower yields than national debt would be a highly attractive instrument for smaller governments, and if combined with fiscal rules – an entry ceiling of 20 per cent of GDP, and a sliding scale of issuance depending on the size of the structural deficit – it would be more likely than a common T-bill to encourage governments to remain close to balance over the economic cycle.

¹⁵ SIFMA, 'Towards a common European T-bill', March 2009.

¹⁶ Eurostat, 'Government finance statistics', May 2009.

The system would also maintain democratic accountability by leaving political decisions about public spending, taxation and debt at national level. In the event of a downturn, governments would be free to run large budget deficits to inject demand into the economy, as happened after the recession of the early 2000s, and as European leaders agreed to do in November 2008. But the debt that incurred would have to be issued through their national – and legally subordinated – debt systems.

This system of rules, underpinned by a common debt instrument, would provide a more effective incentive to balance the budget over the economic cycle than the current system, in which member states police themselves on the European Council, and find it easy to avoid paying fines or simply change the rules in the name of flexibility.

Making sure large economies don't pay for small ones

Germany and France fear that a common bond would increase the cost of their debt, because they would be forced to pay a premium by the credit markets for the increased risk of taking on the debts of eurozone countries in fiscal difficulties. In order to ensure borrowing conditions that are as good or better for Germany and France, there must be strict rules on the repayment of common eurozone debt, enforced by the Commission:

- First, common debt must be legally superior to all the other debt issued by the country in question. As a result, in order to default, a country would also have to default on all of its nationally issued debt – an extremely unlikely occurrence.
- Second, governments would only be liable for the proportion of debt they had issued through each common T-bill and bond. This would mean that if a government defaulted, investors would only face a loss proportionate to that country's participation in the whole scheme, rather than the entire investment. Therefore, they would require a lower yield because they faced a lower risk than if they bought national debt. This also means that the common system would not violate the Maastricht

Treaty's 'no bail out' clause, because governments in the system would be liable for their own debts.

- Third, the fiscal rules laid out above would also prevent governments in fiscal difficulties from issuing debt in the common system and driving up interest rates.
- Fourth, the debt would be issued by the eurozone jointly, but it would be managed by the Commission on its own. As the Commission would enforce rules of entry rather than the Council or the ECB, investors would be less fearful that the issuance rules would be eased or the ECB would inflate the debt away, and would not charge a premium to pay for these risks.

If all of these conditions were fulfilled, Germany and France would in all likelihood see no significant premium added to their debt by investors – they would probably even gain lower yields, as the market developed, and the benefit of the liquidity premium grew.

3. A new pact would promote fiscal discipline after eurozone entry

The Maastricht convergence criteria were much more effective at promoting fiscal consolidation than the SGP has been. While the SGP was based on the Maastricht rules – both mandated a 3 per cent of GDP deficit ceiling, and that any violations need be 'exceptional and temporary' – rules of entry have been more effective at changing behaviour than the rules once the eurozone started. Italy and Greece reduced their budget deficits by 7 and 10 per cent respectively, and all member states had managed to cut their deficit below the 3 per cent ceiling by 1999. Between 1993 and 1997, the average deficit for the eurozone as a whole fell by 3.5 per cent.¹⁷ Even though the mid-1990s were a period of relatively strong growth in Europe, a team of economists found that the various member states' fiscal tightening programmes that started before 1995 were not merely

¹⁷ M Buti and G Giudice, 'Maastricht's fiscal rules at ten, an assessment', 2002.

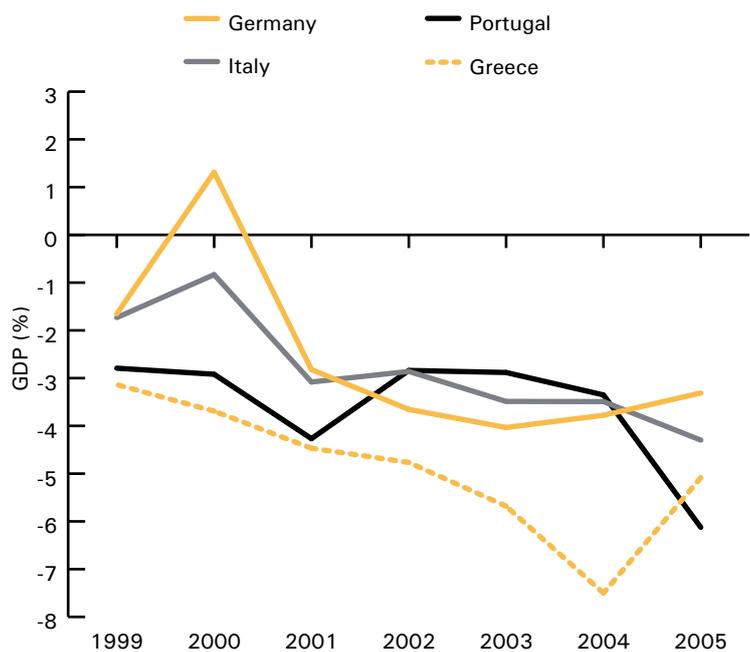
cyclical, and historical data on budgetary behaviour did not explain them.¹⁸

However, after the euro was launched fiscal discipline evaporated (see Chart 4). It is unsurprising that the deficits of several countries went close to or through the 3 per cent level after the 2001-2 recession. But even as the economy recovered, governments were slow to consolidate. In 2005, when most eurozone economies were growing, Greece, Portugal, Italy and Germany were still breaking the rules.

There is a risk, in the medium term, that central and eastern European member states will also loosen their budgetary policies once they enter the eurozone. New accession countries in ERM-II – the second exchange rate mechanism, which commenced in 2004 – are supposed to bring their budget deficits under 3 per cent for more than two consecutive years, as well as keep inflation under control, keep interest rates low, and peg their currency to the euro. Five out of ten prospective euro members were frequently running budget deficits that were higher than 3 per cent before entering ERM-II in 2004 – the Czech Republic, Cyprus, Hungary, Malta and Poland. Since then, only Hungary and Poland have failed to reduce deficits below the ceiling. Between 2001 and 2007, the average budget deficit for the 10 accession countries improved significantly, as they sought entry to the euro after joining the EU (see Chart 5).

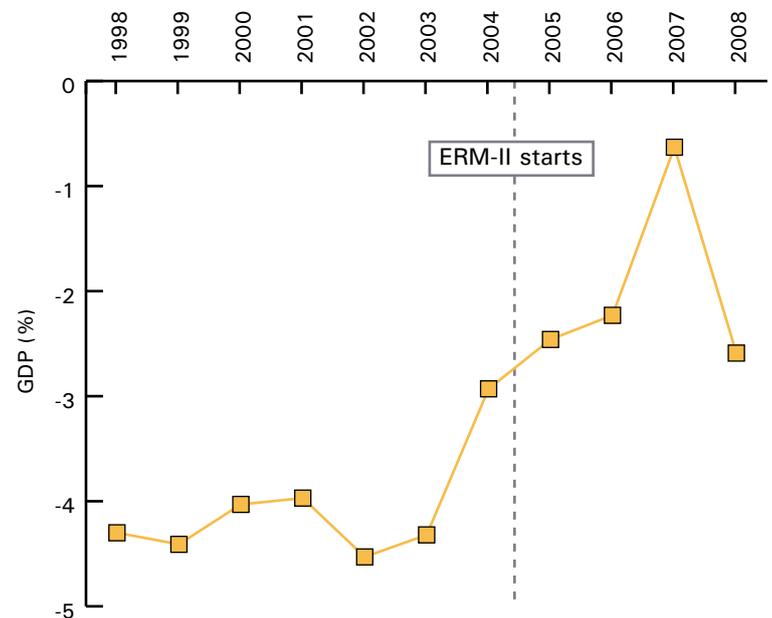
In the current circumstances, the question of eurozone entry for the new EU members may seem far off. The financial crisis is wrecking government finances, and those countries that are trying to stay in ERM-II – Latvia, Lithuania and Estonia – are struggling to maintain their currency pegs as their budget deficits surge beyond 3 per cent of GDP. As a result, they are seeking euro entry as soon as possible, to prevent speculative attacks on their currencies. At the time of writing, however, it looks likely that the ECB and current eurozone governments will insist that they repair their economies and their government finances before they enter, which will take several years.

Chart 4: Evaporating discipline: budget deficits after the launch of the euro



Source: IMF

Chart 5: Improving average government deficit in ERM-II



Source: Eurostat

Regardless of whether these countries join the euro early or not, if current members act quickly to create a common bond system, it would provide an ongoing incentive for new entrants to stick to the rules once they have entered. Unlike the sanctions provided by the SGP, a system underwritten by participation in a common T-bill produces benefits for good behaviour as well as punishments for bad.

18 J von Hagen et al, 'Budgetary consolidation in EMU', 2001.

If it is linked to the SGP, it will take several years for the bond system to become large enough to accumulate maximum benefits for governments, and the entry of central and eastern Europe to the bond system could put upward pressure on the prices markets charge for the common debt. Ceilings on the amount of debt they could put into the bond may have to be lower than for established eurozone members: a top credit rating and low yields should be the priority.

Once inside, entrants would have access to common eurozone bonds if they maintained a tight fiscal policy. In order to maintain the best possible rating for the bonds, the ceilings on the amounts of debt these countries could issue in eurozone bonds could be slowly raised over time to allow markets to adjust – so long as governments remained within the fiscal rules.

Conclusion

If France and Germany are serious about a swift return to the SGP once the recession is over, they would do well to start reforming it now to make it more effective. The original pact was based upon rules that were weakened over time by Germany and France themselves. They were policed by a comparatively weak Commission, which tried and failed to make the Council agree to sanctions. It is difficult to argue that the same arrangement would encourage fiscal consolidation as the economy recovers.

Instead, a Stability and Growth Bond should be appended to the pact, to offer an incentive for governments to raise taxes, cut spending and pay off debt. They should be allowed to issue short term debt through a common T-bill system, which would give them cheaper debt costs when they have stabilised their debt ratios. Their ability to participate in the scheme should be automatically linked to their current fiscal performance, so that prudent behaviour is immediately rewarded

The Stability and Growth Pact should be reformed to offer an incentive for governments to raise taxes and cut spending, and pay off debt. They should be allowed to issue short-term debt through a common T-bill system, which would give them cheaper debt costs, when they have stabilised their debt ratios

with greater participation and therefore lower overall borrowing costs.

These reforms should appeal to Germany, despite its opposition to fiscal federalism. They would be unlikely to raise the cost of Berlin's debt, and may make it cheaper, once the market was established. And they would provide an incentive for governments to keep their budgets close to balance over the economic cycle, preventing high government debts and spending from spilling over into higher interest rates and inflation across the eurozone. Over the medium term, a common bond would also prevent governments in central and eastern Europe from giving up on fiscal discipline once they are allowed to adopt the currency.

In a monetary union, governments need to co-ordinate their fiscal policies to a certain degree, so that they do not pass the cost of their debts on to others. Rules on their own will not work. It is time to offer governments another incentive to cut their debts.

About the author

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