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The Euro Zone Needs an External Stability Pact

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There is widespread concern in the European Monetary Union (EMU) about the sustainability of public finances in a number of member states. In the wake of the financial crisis, their public debt has increased dramatically. Rating agencies have already downgraded some countries' credit ratings, and markets are reacting with higher risk premiums. It is not impossible that certain countries will become insolvent—which could make it necessary for others to assume their debts. This situation has reignited debate on the reform of the Stability and Growth Pact. Yet, as the repercussions of the global crisis show, relying on the rules controlling public deficits and debt may not be enough to prevent the insolvency of member states. Excessive external imbalances of some countries pose a serious danger to the stability of the European Monetary Union. These deficits need to be monitored on the European level in order to mitigate risks as early as possible. An "External Stability Pact" could provide an effective framework for this, complementing the existing body of EMU regulations. Adherence to the provisions of the pact should be made a condition for future enlargements of the Euro zone.

The rating agencies have downgraded European countries like Portugal, Spain and Ireland. For the first time since the inception of the Monetary Union, the markets are differentiating much more strongly among the EMU countries in their risk assessments of foreign loans. The spread in yields on ten-year government loans between Germany and Ireland climbed to almost 250 basis points in March. The loss of confidence in the markets has made some countries' refinancing alternatives significantly more expensive, and this is taking place in an already strained financial situation. In the worst-case scenario, market expectations may become a kind of self-fulfilling prophecy.

Apparently in order to calm the markets, German Finance Minister Peer Steinbrück publicly suggested in February that in the case of a crisis, EMU partners would step in to help bail out any euro-zone member threatened by a payment crisis. This is a reversal of the previous interpretation of the so-called "no-bailout" clause in Article 103 of the EC Treaty: up to the year 2008,

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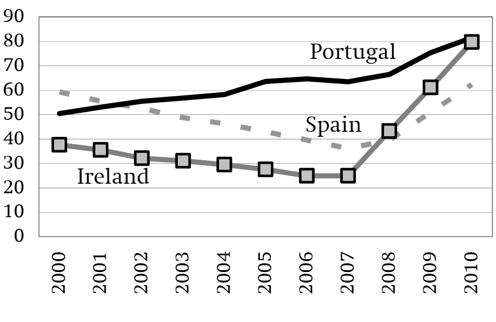
it was repeatedly emphasised that in the European Monetary Union, every country bears sole responsibility for its own debts.

High budget deficits and rapidly increasing government debt form the backdrop to the downgraded assessments of creditworthiness and the increased risk premiums on the credit markets. What is striking about this is that in the last few months, countries have come under pressure whose public finances still seemed sustainable even into last year and therefore were not detected by the early warning mechanisms of the Stability and Growth Pact. Now, the European Commission predicts that from 2007 to the end of 2010, Ireland's government debt will rise from 25 to almost 80 percent of gross domestic product (GDP). The slight budget surplus that Ireland was still able to achieve in 2007 is likely to turn into a deficit of 15.6 percent by 2010. The situation in Spain appears equally dire: the debt ratio threatens to rise to more than 60 percent by the end of 2010, which would effectively amount to almost a doubling since 2007, while the deficit is likely to rise to around 10 percent of GDP.

Government Debt in Ireland, Portugal and Spain, 2000–2010 (as a percent of GDP, projection for 2009/2010)



Causes of the debt explosion

A particularly alarming aspect is that despite the system of regular reporting and the comprehensively detailed provisions of European monitoring mechanisms, these mechanisms failed to predict the extreme debt increase that is taking place in the countries mentioned above. Even in early 2008, the EU Commission forecasted deficits of less than 2 percent of GDP for Ireland by the end of the two-year forecast horizon and a government debt of significantly below 30 percent, while for Spain, they predicted a balanced budget and a decreasing debt ratio.

One reason for the failure of the early warning system is that one crucial variable in the European coordination process has not adequately been taken into consideration: the prevailing high levels of private sector debt. Yet this is the key factor responsible for the current debt crisis in some countries. No member state of the EMU or the EU can afford the bankruptcy of its bank system, which is indeed the backbone of the economy: the negative impacts on growth, employment and future tax revenues would simply be too severe. It is for this reason that in a serious financial crisis, governments are very likely to assume the liabilities of the national financial sector—as recently took place in Great Britain and Ireland, as well as in past financial crises in Latin America and Asia.

The same is probably true when important parts of the business sector are threatened with bankruptcy. In the case of a crisis, the government would probably assume the obligations rather than risk the collapse of large parts of the private sector. In times of high unemployment and especially in the run-up to elections, governments find themselves under intense pressure to take action. In the extreme case, the sum of private debt could comprise many times the sum of the previous government debt—and as can be seen with Ireland, it is quite possible that a country with sound public finances becomes a case for financial reconstruction practically overnight.

Within the European Monetary Union—a community of shared benefits as well as shared risks—a development of this kind is more than just a national problem. Not only is it politically inconceivable to allow an EU or EMU partner to default on their loans; in view of the increasingly close ties in the real economy as well as the financial sector, it would have serious consequences for the entire Euro area and the European economy if one national segment would simply break away. In order to prevent such a situation, the European partners would step in—and thereby indirectly share the liability for private sector debt of other countries. Guidelines for monitoring private debt would therefore be a useful addition to the existing body of fiscal regulations, which up to now has been incapable of identifying such risks early on and restricting those political measures that serve only to exacerbate them.

Imbalances within the EMU

The level of private sector debt in the EMU countries stands in direct relation to the current account imbalances within the euro zone. One talks about imbalances when individual countries exhibit a large surplus or deficit in their current account. A current account deficit means that a country as a whole accumulates foreign debt or sells domestic assets such as equities or land to foreigners. As long as the national budget is not running any (or just a low) deficit, a current account deficit would make it necessary to increase private sector debt abroad or reduce previously accumulated foreign assets. This is not a problem when the current account deficit is financed through a so-called *Greenfield Foreign Direct Investment* (FDI) in the export sector. With these foreign direct investments foreigners invest in new factories that produce for the export sector. The future export revenues ensure that the foreign liabilities from the current account deficit can be serviced. Conversely, a deficit arises when the investing companies import machines or materials.

In a growing economy, moderate current account deficits are acceptable because they can be reconciled with a relatively stable ratio of public debt to GDP. Large current account deficits that are not accompanied by an investment boom in the export sector, however, mean a permanent increase in foreign debt. Sooner or later, a continued high current account deficit has to be adjusted: the debtor countries will either become insolvent or be forced to radically cut spending. In both cases, the country in question will face a crisis. If the heavily indebted private sector becomes insolvent, the government could soon be on the verge of insolvency as well, whether due to assuming private liabilities or due to losses in tax revenues.

If an individual euro-zone country's foreign debt rises, this is a more significant problem than when the same country accumulates excessive debt towards its own citizens. Since the member states' governments still possess fiscal sovereignty over their respective territories, they can still, if necessary, take measures to improve their financial situation, for example, by imposing higher taxes or capital levies on their citizens. But if a country is struggling with high foreign debt, this option does not exist: the country as a whole lacks the net assets to pay its obligations.

For these reasons, the monitoring of foreign debt should play a significantly increased role within the euro zone. If foreign debt is assessed together with the public deficit, it becomes possible to draw conclusions about risky debt trends in the private sector—one of the most important causes of the rampant debt crisis currently afflicting a number of EMU countries.

Risky debt accumulation

Even before the beginning of the financial crisis, risky debt trends had already emerged in some countries. A number of deficit countries such as Greece, Spain, and Portugal ran foreign trade deficits of up to 10 percent of GDP. In Spain, the net foreign asset position deteriorated from almost minus 12 percent of GDP in the year 2000 to minus 76.8 percent in the year 2007. The net foreign asset position is the sum of all of a country's claims on and liabilities to the rest of the world; a negative value can be interpreted as net foreign debt. Even if no comparably precise data exist for Portugal or Greece, these two countries may well have undergone a very similar development in view of their enormous balance-of-payments deficits. In Ireland, on the other hand, the deficit situation worsened severely only just before the crisis.

The balance-of-payments deficits of some countries stand in stark contrast to the enormous surpluses that other euro-zone countries have generated—countries like Germany, the Netherlands, and Finland. For a long time, France and Italy generated only moderate foreign trade deficits. According to recent EU projections, however, the situation in France is currently getting worse. Since the deficits and surpluses within the euro area have to add up to zero overall given the almost balanced external account for the euro area as a whole over recent years, the high deficits of some countries have a direct connection with the high surpluses of other EMU members.

The problem of differing demand trends

On closer examination, the economic development in the individual EU countries displays the following: the imbalances of payments are the result of a very unbalanced development of different demand components. In countries like Spain, Portugal, and Greece, economic growth in recent years has been generated mainly by increased consumption and construction projects. This caused an increase in imports, which in turn helped to cut deficits. In Germany, in contrast, private consumption stagnated to a large extent; the impetus for growth came almost exclusively from exports and investments in the export sector. As in other countries with weak domestic demand, the high growth in foreign demand in Germany led to increased surpluses.

To some extent, these developments are a consequence of the respective national-level economic policies: in Spain, for example, the tax treatment of real estate fuelled the building boom, while in Germany, labor market reforms increased competitiveness and export growth but also weakened domestic consumer demand.

In part, these divergences result from the fact that the EMU member states no longer have their own independent monetary policies that could counteract imbalances in national demand trends. This in turn amplifies national economic fluctuations. If a country's economy is expanding above trend, the results are higher wage settlements and rising inflation rates. The country loses competitiveness, but the higher inflation also leads to lower real interest rates—and that in turn leads to short-term relief in the financing costs and thus stimulates investment, especially in domestic residential construction. At the same time, debt levels increase—because the decreasing competitiveness causes an erosion of the trade balance. Only when the loss of competitiveness becomes so oppressive that it offsets the positive effects of higher national inflation does the boom come to an end. Normally, under the conditions of the EMU, a phase of strong economic growth can persist for an extended period of time, and national competitiveness can shift significantly further away from long-term balance than would be the case with a national monetary policy.

A boom of this kind is followed by a long phase of weak growth in which the preceding loss of competitiveness has to be adjusted. This takes place through wage agreements in some countries that lie below the level of the other EMU countries, which leads to lower national inflation, higher national real interest rates, and thus weaker domestic demand. During this kind of cycle, a country's debt can increase to such an extent that it runs into solvency problems.

Up to now, the approach in the European Monetary Union was to rely on market mechanisms to balance divergences in demand in different member countries. The Lisbon Agenda for Growth and Employment serves among other things to improve the transnational function of market forces. The limitations of the Agenda's impact, however, are well known. As an alternative or an addition to the Agenda, national economic and tax policies could be coordinated much more closely in order to achieve a more homogeneous demand development within the EMU. Yet this option is difficult to implement under current conditions because the existing EC law only provides for voluntary coordination of national economic policies. A transfer of authority to the EMU level may seem like the sensible solution from an economic point of view, but at present, it is politically unrealistic.

A different approach would be to create a fiscal compensation mechanism for imbalances. A larger EU budget could thus influence the demand in individual regions through revenues and expenditure. The centralised budget would help curb divergences between national demand trends and help to mitigate the inherent tendency in a monetary union of regional boom-and-bust cycles. By so doing the euro zone would come to resemble the structure of other federalist countries like the USA and Germany.

The question, however, is whether this kind of centralisation of fiscal policy—even if it were politically feasible—would be enough to rectify the imbalances in the debt trends in the Monetary Union. Recent research findings suggest that one problem in the EMU is the divergent wage developments in the different countries, which persist beyond economic cycles. This is a result of the differences between the national wage-setting systems and labor market policies. Economic divergence can therefore hardly be corrected through fiscal policy alone—rather, it should be seen as a component of strengthened structural policy and macroeconomic coordination.

Preventing imbalances at an early stage

Monitoring the external balance would be an important component of measures to prevent future macroeconomic imbalances, since sustained current account deficits or surpluses end up being reflected in a constantly growing net foreign debt or in continuously increasing net foreign assets. The existing system of fiscal surveillance should therefore be expanded to incorporate a "Stability Pact for External Balances."

Such a pact would need to stipulate that no euro-zone country may have a current account imbalance of more than 3 percent of GDP, either as a deficit or as a surplus. This 3 percent could be adjusted to take into account inflows or outflows of foreign direct investment in new factories (greenfield investments), which would allow countries to import more during an investment boom. The value of 3 percent was not chosen in analogy to the Stability Pact, but is rooted in the mathematics of debt calculation: if a country shows a yearly balance-of-payments deficit of 3 percent of GDP, then at an expected average nominal growth rate of 5 percent annually, the level of foreign debt will stabilise at below 60 percent of GDP. This value should be seen as acceptable based on experiences with previous financial crises, whereby higher levels of debt have frequently resulted in balance-of-payments crises. The adjustment to include foreign direct investment is permissible because it does not affect a country's debt levels, but rather can even help to improve the balance-of-payments position if investments have been made in the production of tradable goods.

As with the existing Stability Pact, exceeding the threshold for balance-of-payments imbalances would initially result in warnings to the member state, followed by the determination of appropriate measures to bring the imbalance down. If this adjustment does not occur, sanctions could be imposed—given a correspondingly adapted legal framework—for example, halting financial transfers from the EU budget, stopping the provision of interest-free loans, or even imposing fines on the member states. These sanctions should take effect automatically. Experience with the Stability Pact has shown that those member states most likely to fear sanctions themselves may shrink back from issuing sanctions against other countries. This also suggests that it would be advisable to grant the European Commission a stronger role in the enforcement of the mechanisms.

As an additional element, the Stability Pact for External Balances should involve monitoring the debt development of specific countries' financial sectors in order to identify risks at an early stage that are not apparent in the current account deficit. The Pact should apply both to debtor countries as well as to surplus countries, since imbalances of payments always have two causes—a country that absorbs more than it produces, and a country whose demand is lower than total economic output. Furthermore, it is almost impossible for deficit countries to correct their current account when demand in the surplus countries remains weak over the long term.

Avoiding risks while maintaining autonomy

The Stability Pact for External Balances would oblige every country to orient its own national economic policies towards achieving a foreign economic balance. First and foremost, this would mean using the tools of fiscal and wage policy as well as general economic policy, since the member states no longer create their own monetary policies. This pressure on national policy to adapt would not be a disadvantage, but would in fact be the objective of the new pact. It could thus offer a means of fulfilling the recent demand by German Foreign Minister Frank-Walter Steinmeier for closer coordination of economic policies among the member states.

In comparison to the existing form of economic policy coordination, or to the centralised coordination of European fiscal and economic policy at the EMU level, the Stability Pact for External Balances would offer three further advantages. First, it would lead to a broader coordination of economic policy than is currently the case. This would especially have an impact on the wage-setting systems of the individual countries—the governments would be compelled to use national legislation and wage settlements in the public sector to influence wage policy in such a way that imbalances among the euro-zone countries could be avoided. This would give countries like Spain—which still partly indexes wage increases in relation to the inflation rate, thereby exacerbating boom and bust cycles—another argument to use in the domestic policy debate for prohibiting such contract clauses. This would not be a direct infringement on the negotiating autonomy of the bargaining parties, but would force governments to create an EMU-compatible framework.

Second, the Pact would oblige the individual EU countries to take the consequences for other member states into account when designing their own national economic reforms. Each country would have to ensure that any effects on neighbouring countries (for instance in the form of excessively high surpluses on their own side) would not be too severe. If a surplus country wanted to lower non-wage labor costs and increase value-added tax in order to boost domestic economic competitiveness, under the new rules it would have to simultaneously compensate for the negative effects on its partners' foreign trade through an expansive fiscal policy. Early information would also allow the EU partners to consciously decide for or against measures that could counteract the threat of trade imbalances resulting from unilateral increases in competitiveness in other EU countries.

Third, in the framework of the new regulations, the individual countries would retain the authority to design their own economic and fiscal policies. Each one would have the freedom to decide what means they might want to use to avoid massive foreign trade imbalances. The Spanish government, for example, could have met the building boom and the foreign trade deficit with tax increases—or by urging the social partners to exercise wage restraint. As an alternative, it could have intervened by instituting planning regulations or a legal lending limit for mortgage loans.

The Pact would improve economic policy coordination among the individual states. It would be an effective instrument for putting a fundamental principle of primary law into practice, namely that the member states see economic policy as a “common interest” (Art. 99 EGV). Experiences in recent years have shown that this goal can be achieved most effectively through a stronger framework for national economic policy.

The proposed Pact would be a significant step forward toward more economic policy coordination. In view of the developments in the Monetary Union during the first ten years of its existence, it appears more important than ever to keep the euro stable over the long term. At the same time, no authority would be shifted to a higher level; at present, no majority would vote in favor of such a change. Policy planning will thus remain in a prescribed framework at the national level. The Pact would strengthen the regulated coordination of national policy—with the goal of keeping the distortions and destabilisations that normally arise from purely nationally-oriented policy-making to a minimum.

Design of the new pact

The Stability Pact for External Balances should include above all the member states of the European Monetary Union; but it could also be developed to include all of the EU countries. The Pact would be useful for the EU as a whole in that it would limit the economic imbalances in the internal market and thus prevent the need for radical adjustments, for example, of the exchange rate. But the Pact is much more important for the euro-zone countries than for the EU overall. First of all, the non-EMU countries will still have national monetary policy and the exchange rate as a means of adjustment at their disposal. Secondly, in their case, negative spillover effects will have a less severe effect on other EU countries than is the case within the single currency zone.

The new pact should not be designed as a merely voluntary commitment by the signatories. In the past, especially in the framework of the Eurogroup, sensible agreements have been made repeatedly but then abandoned again in the process of implementation as soon as they came into conflict with national priorities. Furthermore, informal agreements cannot provide the basis for a structured monitoring process that is founded on national reporting systems and at the same time guarantees the Commission a central role. The use of a sanction mechanism would be even more inconceivable in this context.

The Pact for External Balances should therefore be created—similarly to the Stability and Growth Pact—on the basis of a regulation adopted by the Economic and Financial Affairs Council. The new agreement could be integrated into the Stability and Growth Pact if it needs to be reformed again due to the fallout of the economic and financial crisis. The foreign economic balance could then be included in the Stability and Growth Pact as an additional element of fiscal and economic policy coordination. If no reform is planned, the External Economic Pact could be realised independently of this element.

The regulations would ideally apply to the entire EU-27, but in the absence of political agreement, it should at least be introduced for the countries of the euro zone. Candidates for EMU membership should also fulfill its objectives. This should not be interpreted as an attempt by the old members to create entry barriers; rather, the Pact would protect countries from introducing the euro too soon, which could have very costly consequences. Ultimately, competitive disadvantages will be rendered permanent if countries with a clear foreign economic disadvantage enter the EMU. For example, Portugal's convergence process in per capita income has reversed since the country joined the EMU—this case shows that overly hasty introduction of the euro can entail high medium and long-term costs, in the form of unemployment and declining growth.

Long-term interests in stability

One could think that finding a majority among the EU member countries for such a pact would be difficult. After all, deficit as well as surplus countries would be forced to adjust their national policies. However, for the deficit countries, the pact has a clear advantage over the status quo: The adjustment burden would be shared between the deficit and the surplus countries. This is a change to the situation today where deficit countries of course might run large deficits for a number of years but in a crisis-like situation they are then forced to adjust and bear the economic burden of current account adjustment alone.

At first glance, surplus countries like Germany would seem to have no immediate interest in introducing these rules given the country's traditionally high current account surplus. But from a medium-term perspective, a cost-benefit analysis leads to the opposite conclusion.

Germany, as the largest economy in the euro zone, with strong trade links within the EU, has a significant interest in seeing the Monetary Union succeed. At the same time, it must be important to Germany that the economic and political tensions within the EMU be kept to a minimum in order to guarantee that the European economy functions efficiently. Furthermore, Germany would likely be among the main payers if a bailout became necessary.

In adddition, the crisis-level distortions of trade in the Monetary Union that might result from a debt crisis in an individual country would quite likely hit the Federal Republic the hardest. A prime example of this connection can currently be seen in the sharp decline in German exports in the wake of the global financial crisis.

One should also keep in mind that the problems described threaten to become worse with a possible expansion of the euro zone. The next candidates to join the EMU include the Baltic countries, which have shown much more severe foreign trade imbalances than Spain, Ireland, or Greece. This makes it appear even more crucial to make the Foreign Economic Stability Pact a reality.

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