Discerning Europe's fiscal situation

Deepanshu Mohan is Senior Research Associate at the Jindal School of International Affairs, OP Jindal Global University

Since the Great Recession began in 2007-08, global debt and leverage have continued to grow. From 2007, through the second quarter of 2014, global debt grew by $57 trillion, raising the debt to GDP ratio by 17 percentage points. This is not as much as the 23 point increase in the seven years before the crisis, but enough to raise fresh concerns. Governments in advanced countries, including in the European Union, have borrowed heavily to fund bailouts in the crisis and offset falling demand in recession. See the figure given below:

The high debt situation in Europe, particularly, has been a cause of concern related to the slowdown in growth accounting numbers and a higher risk to financial crises (debt induced crises). Given the magnitude of the 2008 crisis, it has been quite surprising to see (Figure 2) that no major economies and only five of the developing countries have actually reduced their ratio of debt to GDP in the 'real economy' (households, non-financial corporations and governments excluding the financial sector). In contrast, Mackenzie Consulting in its latest report finds out that 14 countries have increased their total debt to GDP ratios by more than 50 percentage points. Figure 2 and 3 give us a good indication on this.

On 8th December 2011 Thomas J Sergent[1], in a Nobel Prize winning lecture, presented an interesting historical case study of the United States in reference to the large debts accumulated during the US War of Independence which led to a US fiscal crisis in the 1780s. The analogy of America's historical fiscal situation then, if given relevance, certainly seems to have a critical lesson and bears similarity with Europe's plight today. In a press release that jolted the markets a few days back, the ECB recently announced it will no longer accept Greek government debt as collateral. Though only time will tell how this is likely to impact the Greek economy and its fate in the Union. But Greece is not the main problem but just the tip of the iceberg if we look at the region as a whole.

History tells us that democracies have a tendency to balance conflicted interests. The case of America's constitution history in the late 18th century provide episodes on the government net of interest surplus process and therefore the value of government

Figure1. Global debt has increased by $57 trillion since 2007, outpacing world GDP growth

Global stock of debt outstanding by type[1]
$ trillion, constant 2013 exchange rates

	Q4 2000	Q4 2007	Q2 2014[1]
Total	87	142	199
Household	19	33	40
Corporate	26	38	56
Government	22	33	58
Financial	20	37	45
Total debt as % of GDP	246	269	286

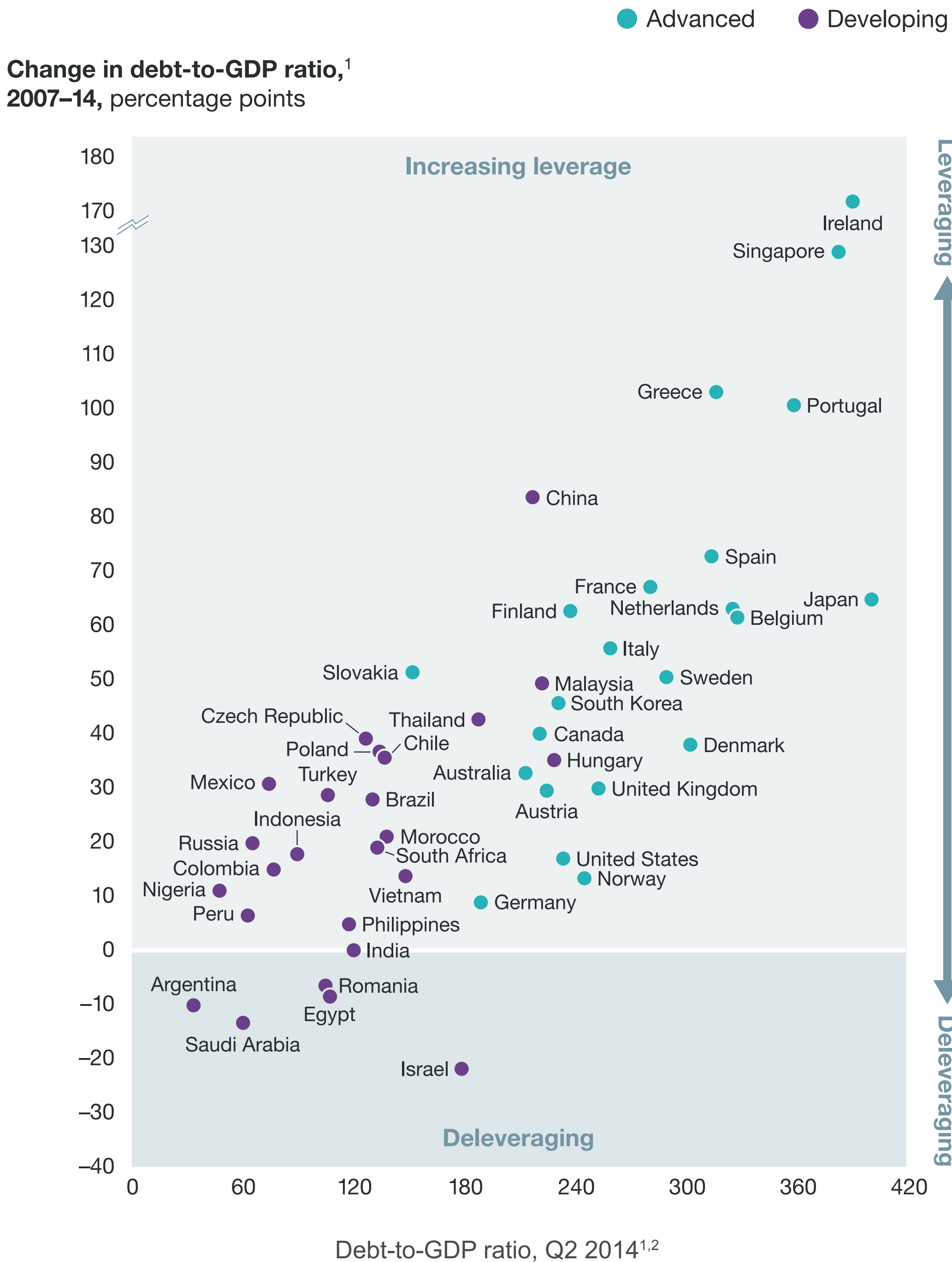
+57 trillion

Compound annual growth rate (%)	2000-07	2007-
Total	7.3	5.3
Household	8.5	2.8
Corporate	5.7	5.9
Government	5.8	9.3
Financial	9.4	2.9

1. 2Q14 data for advanced economies and China; 4Q13 data for other developing economies. Note: Numbers may not sum due to rounding.

Source: Haver Analytics; national sources; World economic outlook, IMF; BIS; McKinsey Global Institute analysis

Figure 2. The ratio of debt to GDP has increased in all advanced economies since 2007



1. Debt owed by households, non-financial corporates, and governments.

2 2Q14 data for advanced economies and China; 4Q13 data for other developing economies. SOURCE: Haver Analytics; national sources; McKinsey Global Institute analysis

debt. Americans in the late 18th century tried two of them; first the Articles of Confederation that were ratified in 1781, and then the US Constitution that was ratified in 1788.

These constitutions pointed out by Sargent embraced two very different visions of a good federal union. The first constitution was designed to please people who preferred a central government that would find it difficult to tax, spend, borrow and regulate foreign trade. The second served opposite interests. Europe today is in a serious need of seeing such a transition to cater to contrary interests of the people across European nations today. The US framers abandoned a first constitution in favour of a second because they wanted to break the prevailing statistical process for the net-of-interest government surplus and replace it with another one that could service a bigger government debt[2].

The issue here, thus, seems to be much more fundamental for Europe and its member nations that is distant from the monetary or financial woes of the region. The region once (and probably still in a lot of academic discourse) is cited as a benchmark example in the process of regionalization for economies to better engage in trade, commerce and address structural socio-economic problems collectively as a region.

“Europe made a serious mistake... by not strictly keeping a check on the implementation guidelines of the Maastricht Treaty”

As a monetary union, the European region might have done well to have established the euro as a common currency and in gaining a uniform consensus amongst most member nations on that (with the exception of the UK as a big player). However, not safeguarding sustainable fiscal targets at the macro and micro level (within the member countries) is a major problem.

Re-echoing Sargent’s arguments, confused monetary-fiscal coordination at a country or regional level creates costly uncertainties. Fiscal and monetary policies are always coordinated and are always sustainable, even though they may be obscure. For the US, they coordinated them by adopting a commodity money standard and restricting states and banks’ ability to create fiduciary monies. Europe made a serious mistake, especially the European Central Bank, by not strictly keeping a check on the implementation guidelines of the Maastricht Treaty (under the Stability and Growth Pact) in 1992 with reference to keeping a 3% of the Government Debt to GDP ratio target for all member nations. A pertinent fact worth mentioning here is that the first country to break this 3% fiscal target was Germany and not Italy, Portugal, Greece nor Spain (PIGS). The PIGS nations just followed Germany’s suit but situation got worse for them vis-à-vis Germany[3].

In terms of fiscal arrangements, the EU today has features reminiscent of the US under the Articles of Confederation. The power to tax and other fiscal instruments lie with the member states. Unanimous consent by member states is required for many important EU-side fiscal actions. As Sargent says:

> *“Reformers in Europe today seek to redesign these aspects of European institutions, but so far the temporal order in which they have sought to rearrange institutions has evidently differed from early US experience in key respects. The US nationalized fiscal policy first and for the US framers, monetary policy did not mean managing a common fiat currency, or maybe even having a common currency at all. The EU has first sought to centralize arrangements for managing a common fiat currency and until now has not wanted a fiscal union. And to begin its fiscal union, the US carried out a comprehensive bailout of the government debts of the individual states. So far, at least, the EU does not have a fiscal union, and dew statesmen now openly call for a comprehensive bailout by the EU of the debts owed by governments of the member states.”*

The policymakers need to identify the eurozone as one single country, like the US or the UK if they have to ultimately solve EU’s problems. The US until quite recently was also undertaking significant austerity measures, even though there was no significant market pressure to do so. The main argument for doing so is that the government debt has been too high. The common fiscal policy needs to be countercyclical and not pro-cyclical and Keynes today would have said exactly this. However, the political considerations and situation would need an 18th century US-like transformation to cater for Europe’s stability and existence in the future. ■

1. Link to the complete lecture and paper: http://ec.europa.eu/economy_finance/economic_governance/sgp/index_en.htm
2. The term ‘framers’ used by Sargent In his lecture instead of ‘founders’ or ‘founding fathers’ is more descriptive of how they thought of themselves, namely as creators of an institutional framework within which their successors would act. See Rakove (1997).
3. One of the reasons why Germany was able to keep a check on its debt levels was by keeping a large reserve base of foreign currency reserves and also by containing inflation over time.