1. THE FUNDAMENTAL PROBLEM

The most convincing justification for the Stability and Growth Pact (SGP) is the existence of a severe free rider problem in a monetary union (MU) with a number of large countries. Ever since it was discovered (probably by the Emperor Diocletian in the second century) that inflation can be used to reduce the government’s debt burden, a ‘fatal nexus’ has existed between government debt and governmental control over initially the mint, then the printing press and finally the central bank. Not only is it possible for a government that controls the creation of money to reduce its real debt burden by generating inflation, but this fact is known to money holders and affects their willingness to hold government created money. Negative effects on economic efficiency, savings, economic growth and even on so called seigniorage (government revenue from the creation of money) follow from the ‘option to inflate’ held by all governments.

A number of mechanisms have therefore been invented to try and eliminate (or at least severely limit) this option. They include fixing the parity of the state issued currency to one which is not so issued (the gold standard, currency boards, unilateral dollarization or euroization) and establishing an independent central bank. One problem has nevertheless persisted: how binding will such constraints on a government’s monetary behavior be when it actually faces the choice between debt default and breaking or rewriting such self imposed rules? Recent experience in Argentina suggests that ‘monetary rules’ may not be very binding in this situation, even if the final result in Argentina turned out to be both the breaking of the rules and government debt default.

The result has been growing interest in ‘fiscal rules’ which are designed to prevent public debt from reaching a level at which it could become unserviceable, and might therefore present a temptation for government to inflate it away. Gordon Brown’s self-imposed so-called ‘golden rule’ is an example from Britain\(^1\), while the Polish constitutional limit on public debt to 60% of GDP is another.

The problem of the link between fiscal and monetary prudence takes on an extra dimension in a MU which consists of a number of large, independent, fiscal
jurisdictions. In the case of many small fiscal jurisdictions (countries or states) in the monetary union, a jurisdiction which borrows irresponsibly will become bankrupt before it affects the creditworthiness of the entire union (in the absence of a bailout promise from the others). This is the case of the United States. In the case of one very large and many small jurisdictions in the union, the small countries will be in the same situation as above, while the large jurisdiction will not be able to free ride on the reputation of the small ones, because of the large impact its indebtedness is likely to have on the exchange rate of the union currency. The eurozone seems to fit in the intermediate range, in which jurisdictions are small enough to be able to benefit from the credibility others give to the union currency, yet large enough for their bankruptcy to have large spillover effects on the union currency and other jurisdictions.

Furthermore, the Germans have traditionally feared the following scenario: less monetarily and fiscally prudent member states (MS) would take advantage of the increased credibility and lower interest rates which a European MU would bring in order to increase their public debt to levels at which the monetary rules of the union would loose their credibility. In anticipation of the ensuing future inflation, interest rates would rise for all. In exporting German monetary credibility to all, the EMU would then end up by importing other members’ lack of credibility to Germany.2

Nor is such a fear fanciful. Germany and other traditionally prudent countries such as Austria and the Netherlands are massively outvoted on the existing Governing Council of the ECB, and will be so even more after enlargement of EMU to the East.

An additional problem is that the ECB does have some responsibility for the stability of MS’ banking systems. Given the high levels of government debt held by banks in many EMU MS, in the case of default by an EMU member government it could be legitimately argued that this responsibility requires intervention to save the banking system of the country concerned. Given the extremely limited capital resources of the European System of Central Banks such intervention could only take the form of generating inflation.

There is also a further, deeper, problem. Whereas the ECB could allow small countries’ governments to default on their public debt, the consequences of allowing a major state to default and its banking system to collapse could be massively depressive for the whole union. In the absence of a MU, such a situation could be avoided by the affected country inflating the problem away. Within the eurozone it can only be avoided by the ECB generating inflation in the whole MU.

The special problem posed by the existence of a few large independent fiscal jurisdictions within a MU is highlighted by the absence of any federal level fiscal rules binding on individual states in the USA. This is partly the result of most states having state-level balanced budget rules. But it may also result from the fact that there are 50 states, with California (the largest) accounting for one eighth of the union’s GDP (and about one sixteenth of government expenditure in the USA), as compared to the 30% weight of Germany within the eurozone.

Fiscal rules in a MU with a few large independent fiscal jurisdictions are therefore even more important for guaranteeing the long-term credibility of its monetary rules than they are in a unitary state.