

"'Excessive Deficits':
Sense and Nonsense in the Treaty of Maastricht"
Comments on Buiter, Corsetti and Roubini

Presented at panel meeting, Economic Policy, Centre for Economic Policy Research, London, United Kingdom, October 15-16, 1992. Revised March 1993.

Jeffrey A. Frankel
Professor of Economics
University of California
Berkeley, CA 94720 USA

Buiter, Corsetti and Roubini (1992) is a nice thorough review of the issues surrounding the fiscal criteria that were adopted by the EC leaders in December 1991. It is no less relevant for the serious setbacks that European Monetary Union has sustained in the meantime. In my view the authors can dispense with their worries that theirs is an exercise in "necrophilia." Economists have been pointing out serious problems with the plans for EMU from the beginning.¹ Often we have been told that our points are not politically relevant, because EMU is already a "done deal". Now that the deal appears to have come "undone," it is a good time to review the problems, perhaps with the aim of improving the specifications of a reborn Maastricht Agreement [or, more pessimistically, with the possible outcome of concluding that EMU is too difficult an enterprise for Europe to undertake, at this stage in history].

The Maastricht Agreement included a list of "musts," economic criteria that members of the EC 12 must meet by the end of the decade if they are to be eligible for membership in EMU. Of these musts, the exchange rate, inflation, and interest rate are all clearly relevant variables, since monetary union will mean giving up independent monetary policies. But the central focus here is on the fiscal criteria -- limits on the budget deficits and debts, as fractions of GNP. The proposal to include these criteria, which originated in the Delors Report, struck

many as surprising.

The authors show that, whether judged by historical standards or by the likely macroeconomic effects, the fiscal criteria are severe (the "musts strict"). The debt criterion (60% of GNP) is so tough -- requiring severe contractions particularly in Italy, Greece, Ireland and Belgium -- as to make it very unlikely to be seriously attempted.

The authors report results of several econometric simulations of the likely effects of meeting the budget deficit criterion. One simulation study was conducted at the Research Department of the International Monetary Fund, and reported (prematurely and inaccurately) in French newspapers in the summer of 1992. The IMF study had two scenarios. The first assumed that European interest rates come down, because high credibility is established; it forecast a cumulative output loss of 0.4 per cent. The second scenario assumed that investors remain skeptical for the time being, and interest rates stay high; it forecast a cumulative output loss of 0.8 per cent. Much of the lost GNP occurs in Italy.²

The authors point out that it might help to choose between these two scenarios if one could decompose observed interest differentials, which are still substantial across Europe, into components due to the possibility of future exchange rate changes and a component due to the risk of default or other "country risk." I have referred to these two components of international interest differentials as the "currency premium" and "country premium," respectively. I found that the country premium for most European countries tended in the late 1980s to narrow more rapidly than the currency premium, presumably as the result of the liberalization of capital controls in many EC countries.³ Those results were for short-term deposits. Tests on longer-term bonds are probably more relevant. Giovannini and Piga (1992) find that the country premium or default premium on Italian bonds is relatively low. If low premiums hold up, this would point toward the more optimistic of the two IMF scenarios.

Some leaders who saw the reports of the IMF study reacted by expressing surprise at

the forecasted loss in GNP, and suggested the results might be too pessimistic. Most economists, however, think that the design of the experiments made them, if anything, too optimistic. As the authors note, other studies such as one by Giovannini and McKibbin (1992) show much larger losses.

The central question addressed by the authors, or at least the central question on which I wish to focus, is the following: Why did the European leaders include the fiscal criteria in the Maastricht rules? Notwithstanding plans for monetary union, why not let each country run whatever fiscal policy it chooses, as is the case with states within the United States. If a profligate country incurs a large debt, that will drive up the interest rate premium it must pay to compensate investors for the risk of default.⁴ Ideally this penalty will discourage the country from being profligate in the first place. But even if it does not, what business is that of its European neighbors?

The authors go through a variety of possible reasons why the guardians of EMU included the fiscal variables among the Maastricht criteria. I have added a few to the list. Altogether, I count eight, which I will go through one-by-one.

The first three possible explanations have to do with international externalities of one sort or another.

(1) Fiscal imprudence brings **risk of bailout** by central authorities, either fiscal or monetary. The authors emphasize that Clauses 104 (including 104a and 104b) of the Agreement rule out bailout, but the key question is whether this commitment is credible. History is full of examples where a government stated explicitly that it would not bail out a particular category of borrower, and then was forced to do precisely that when disaster struck and financial or economic collapse seemed to be the only alternative. (One example is the

Chilean government's statements in the late 1970s that it would not take responsibility for privately incurred international debts.) One might object to these examples that it is one thing for a government to face irresistible political pressure to bail out its own citizens or sub-units, and quite another to bail out those of another nationality. This depends on the question of how much "solidarity" exists among nationalities. The authors are rather dismissive of the idea of solidarity, but we shall return to it below.

(2) There is the danger of **spread of fiscal or financial crisis** to neighboring countries. The authors classify this difficulty as one of those that could lead to bailout by monetization. (See "bailout, comma, monetary" above.) But there is the distinct issue of possible debt **contagion**. Latin America provides more examples: in 1982, Colombia was faced with a cut-off of lending as severe as those afflicting its South American neighbors, notwithstanding that it had done a relatively good job keeping its fiscal house in order. Similarly, ten years later, Brazil is facing an inflow of capital along with its neighbors, notwithstanding that it has done a much worse job of putting its fiscal house in order. It is possible that international lenders place too much weight on relatively superficial characteristics like geographical location. In models of bank runs, bandwagons, or bubbles, such behavior need not even be especially "irrational."

(3) There is the much-analyzed factor of **macroeconomic spillover effects** via interest rates and exchange rates. In theory, such effects call for the coordination of monetary and fiscal policy, to improve on the Nash non-cooperative equilibrium. The authors correctly point out the difficulty that model uncertainty creates for coordination. In simulations conducted by Brookings, twelve major econometric models of the world macroeconomy showed a large range of variation in their predictions as to the international spillover effects of specific policy experiments.⁵ The models were evenly split on the sign of transmission of monetary policy.

At the time, there was at least less disagreement as to the sign of transmission effects in the case of fiscal policy than there was for monetary policy. Only one out of ten models

showed negative transmission of a fiscal expansion (Patrick Minford's Liverpool model). But in the years since that experiment was conducted, many of the models have been revised. The McKibbin-Sachs Global model and the IMF's Multimod both now feature negative transmission of fiscal policy.⁶ Such models can easily produce the result that the Nash non-cooperative equilibrium entails competitive real appreciation and excessively expansionary fiscal policies; a Europe-wide agreement would then call for coordinated limits on fiscal expansion. The trouble is, many other models that feature positive transmission will produce the results that the Nash non-cooperative equilibrium entails competitive real depreciation and excessively contractionary, beggar-thy-neighbor, fiscal policies. In that case a Europe-wide agreement would call for joint expansion, as under the "locomotive theory."

In addition to the problems of uncertainty regarding the correct model, I would like to mention the problems of uncertainty regarding the level of potential output, the "baseline" position of the economy relative to potential output, and the proper weight to be placed on stabilizing output versus inflation. Minor errors in the perception of such variables or parameters could cause policymakers to seek coordinated expansion when coordinated discipline was in fact called for, or vice versa.

The next two possible explanations for why the European leaders put fiscal deficits on the Maastricht list arise, not from true international externalities, but simply because the problem of excessive deficits has been on their minds. We begin with the point that realistic political economy models can produce a bias toward excessive deficits. The authors sketch how this bias can arise. Given that the leaders have had excessive deficits on their minds, what is the connection to EMU?

(4) One possibility is that there is no intrinsic logical connection, but that including the fiscal criteria in the Maastricht Agreement was an **easy expression of virtue**. In other words,

"why not?" It is suggestive that these criteria, unlike those for the exchange rate, inflation rate, and interest rate, are not to be strictly enforced, there being several provisions for leeway.

(5) EMU membership, even if not intrinsically connected to fiscal deficits, might be intended as a reward or incentive for good fiscal behavior. The institution would be a device for giving the national governments "backbone," for reinforcing their political will to do to what they should be doing anyway on domestic grounds. The incentive theory is consistent with a special property of the criteria noted by the authors, the leeway provision that takes into account changes in debt: if (for example) Italy succeeds in bringing down its debt from the current high level, it could apparently qualify for EMU, even if its level of debt is still higher than that of a Denmark that has made no progress and fails to qualify. This otherwise-anomalous property can be seen as evidence that the criteria are meant to function as incentives. Some teachers tell their students after the mid-term exam that they will reward those who improve in the second half of the term with better grades. I don't do this myself, because it seems unfair to those with the better performance on average throughout the term (and also because (1) it is a less-efficient scheme for gathering information on the students, and (2) undermines the students' incentive to exert themselves in future courses' first halves.) Nevertheless, those teachers that do pay attention to the rate of improvement probably have the incentive effect in mind.

The authors seem to see no reason why a fiscal commitment mechanism should be installed at the international level rather than the domestic. They mention the Gramm-Rudman-Hollings legislation and proposals for a balanced-budget amendment in the United States as examples. The failure of these mechanisms at the federal level gives grounds for skepticism; the authors list five reasons for worry, concerning such issues as the difficulty of monitoring commitments in the presence of accounting tricks [p.60]. They seem to miss the point, however, that many of the (economically correct) refinements regarding the measurement of fiscal deficits and debt that they suggest earlier in their critique of the Maastricht budget

guidelines [particularly in Sections III.1-III.3, pp.28-36], would make it even more difficult for the man or woman-in-the-street to judge whether the government was honestly abiding by its commitment.

The last set of three possible explanations for the Maastricht criteria are based in the classical mythological notion of the Quest. To begin with classical Greek mythology, a common pattern goes as follows. The hero asks an oracle or king for something, often the hand of the king's daughter. The king sends the hero off on an exceedingly difficult quest, which is supposed to be a test of worthiness. Jason of the Argonauts, for example, is sent off for the Golden Fleece before he can claim his kingdom. At Maastricht, the fiscal criteria are the object of the quest, and EMU membership the prize.

(6) In one version of the quest hypothesis, **the assigned task is clearly meant to be impossible**. In Greek mythology, the quest can be a ruse on the part of the king to get rid of the troublesome upstart. This was the intention of Jason's uncle Pelias, when he sent him in search of the Golden Fleece. Another precedent comes from a more recent golden age, late 19th century America. In The Wizard of Oz, Dorothy and her friends are sent off on a seemingly-hopeless quest for the broom of the Wicked Witch of the West. The wizard has told them that this task is the price for granting their desires (returning to Kansas, in the case of Dorothy); but he is really trying to get rid of them.

The authors mention this possible explanation of the Maastricht criteria as a "Machiavellian plot." Here, Helmut Schlesinger is cast in the role of the wizard, and Frankfurt is the Emerald City. The Bundesbank knows the quest is impossible, but wishes to torpedo EMU. The Wizard of Oz is a fitting allusion, because the story was originally written as a populist allegory about the gold standard and William Jennings Bryan's quest for easier money. Frankfurt would simply substitute for the U.S. East Coast as the perceived home of an elitist

secretive cabal of central bankers set on tight money, high interest rates, deflation, and the bankruptcy of indebted farmers.

(7) The next possibility is that the difficulty of the task is designed **to make EMU seem like a more desirable goal**. I intend this explanation half-facetiously. But it is striking that the only two major countries that currently meet the Maastricht criteria are also the two where the electorate has declared itself ambivalent about EMU (Denmark and France; I am not classifying Luxembourg as a "major" country). At the same time, the countries where the fiscal criteria look least attainable, especially Italy, are where EMU is most popular. (Also some countries like Sweden, that are not even eligible at this stage, seem more anxious to participate than do many of the EC 12.)

(8) A more serious version of the classic quest, and the one to which I incline as an interpretation of Maastricht, is that the criteria are a **test of will**. Visionary political leaders, for political reasons, sometimes seek monetary integration before their countries are truly ready for it. The theory of optimum currency areas says that a country should not give up its currency and its monetary independence unless it is willing to share the monetary policies of its neighbors. If it tries, the first major economic shock that comes along will have disruptive effects, unless the shock hits all members in the same way, and unless they place the same priority in their desired response on stabilizing output versus inflation. If the countries' populations desire to respond to the shock with different monetary policies, and they are not willing to sacrifice their desired policies for the greater cause of monetary union, a crisis will follow.⁷ If the monetary authorities respond to the will of the national constituency, the crisis will occur in the foreign exchange market; if they do not, the crisis will take a political form.

We saw these old truths illustrated in Europe in 1992. The shock was the German spending associated with the earlier incorporation of the Eastern Lander, and the crisis in this case occurred in both the foreign exchange and political arenas. In my view, Europe is

fortunate that the shock came along as early as it did. The embarrassment and disruption would have been worse if the crisis had occurred during Stage II.⁸

The tests of will that are the most relevant to the Optimum Currency Area question are thus really tests of national willingness to give up independent will. Perhaps the best mythological precedent comes neither from Ancient Greece nor America, but from Asia. In Buddhist tradition, the hero's quest lies not in overcoming external obstacles, but rather in self-abnegation, in elimination of one's ego or will. A meditating neophyte is supposed to learn to refrain from responding to a flea by scratching it, just as a political region is supposed to learn to refrain from responding to a local downtick in demand by lowering interest rates.

The fiscal criteria are less directly relevant to the Optimum Currency Area question than the other Maastricht criteria. But precisely because they are so difficult, they offer a test of strength and will. They, even more seriously than a referendum, force the constituencies within a country to confront the question of how badly they want EMU.

In Greek mythology, King Aegeus placed his sword and sandals under a large stone, and left behind instructions that only when his son Theseus was able to lift the stone and take the sword and sandals should he come to Athens to claim his kingdom. Theseus' mother waited before telling him even to try to lift the stone, until he was old enough and strong enough to do it easily. The European countries are not yet ready to lift the Maastricht stone. But perhaps that is as it should be.

* * *

References

- Alesina, Alberto, Mark de Broeck, Alessandro Prati and Guido Tabellini (1992). "Default Risk on Government Debt in OECD Countries," Economic Policy 15 [Oct.], 428-451.
- Argy, Victor, and Joanne Salop, (1979). "Price and Output Effects of Monetary and Fiscal Policy Under Flexible Exchange Rates," IMF Staff Papers 26, 224-256.
- Buiter, Willem, Giancarlo Corsetti, and Nouriel Roubini, (1992) "'Excessive Deficits': Sense and Nonsense in the Treaty of Maastricht," Economic Policy 16, forthcoming.
- Fitoussi, J.P., and E. Phelps, (1986). "Causes of the 1980s Slump in Europe," Brookings Papers on Economic Activity 2, 487-513.
- Frankel, Jeffrey, (1988). "Ambiguous Macroeconomic Policy Multipliers in Theory and in Twelve Econometric Models," In Empirical Macroeconomics for Interdependent Economies, eds., Ralph Bryant, et al., Brookings Institution: Washington, D.C., 17-26.
- Frankel, Jeffrey, (1991). "Quantifying International Capital Mobility in the 1980's," in National Saving and Economic Performance, D. Bernheim and J. Shoven, eds., University of Chicago Press: Chicago, 227-260.
- Frankel, Jeffrey, Steve Phillips and Menzie Chinn (1992). "Financial and Currency Integration in the European Monetary System: The Statistical Record", NBER Working Paper No.3819; forthcoming in The Transition to Economic and Monetary Union in Europe, edited by Francisco Torres and Francesco Giavazzi, Banco do Portugal, Lisbon, and Centre for Economic Policy Research, London.
- Giovannini, Alberto, and Warwick McKibbin, (1992). "The Economic Consequences of Maastricht," The Brookings Institution, May.
- Giovannini, Alberto, and Gustavo Piga (1992). "Understanding the High Interest Rates on Italian Government Securities," Columbia University, May.
- Goldstein, Morris, and Geoffrey Woglom (1992). "Market-Based Fiscal Discipline in Monetary Unions: Evidence from the US Municipal Bond Market," in M.Canzoneri, V.Grilli and P.Masson (eds.), Establishing a Central Bank: Issues in Europe and Lessons from the US, Cambridge University Press, Cambridge.
- International Monetary Fund, (1992). "The Macroeconomic Effects of Convergence in the European Community," Annex III to World Economic Outlook, September.
- McKibbin, Warwick J., and Jeffrey D. Sachs, (1991). Global Linkages: Macroeconomic

Interdependence and Cooperation in the World Economy, Brookings Institution: Washington, D.C.

Portes, Richard (1992). "After the Fall: EMS and EMU," Centre for Economic Policy Research, London.

Sachs, Jeffrey D. (1980). "Wages, Flexible Exchange Rates, and Macroeconomic Policy," Quarterly Journal of Economics 94, 731-47.

* * *

Footnotes

- . Portes (1992) reminds a surprised world of some of these warnings.
- . IMF (1992).
- . Frankel (1991) and Frankel, Phillips and Chinn (1992).
- . Goldstein and Woglom (1992) and Alesina, de Broeck and Prati and Tabellini (1992) find significant correlations between the size of public debt and the interest rate premium. (The tests apply to samples of U.S. states and OECD countries, respectively.)
- . Frankel (1988), and other papers in the volume.
- . McKibbin and Sachs (1991). The negative transmission comes when the appreciation of the currency of the expanding country raises real wages among its neighbors (as in Argy and Salop (1979), Sachs (1980), and Fitoussi and Phelps (1986)). These econometric models also seem to predict negative transmission from German fiscal expansion to other European countries, even with a fixed exchange rate. This effect may come through implicit monetary contraction.
- . One can give a more complete list of the criteria that determine when a unit is small enough to merit submerging itself into a larger currency area. (1) Openness with respect to trade determines the magnitude of the benefits to a fixed exchange rate. The other characteristics concern the costs of giving up monetary independence. As noted, the need to respond independently to disturbances will be small if: (2) shocks are highly correlated with those of neighbors, (3) similar weights are placed on inflation and output stabilization and (4) the unit is politically willing to make sacrifices for the sake of monetary union. In addition, the need for a deliberate independent monetary policy response will be smaller if there exist alternative ways of coping with a shock, namely if: (5) labor mobility is high, or (6) other units in the union are willing to transfer funds. Items (4) and (6) relate directly, and items (3) and (5) indirectly, to the question of "solidarity" among nationalities. But if solidarity is a requirement for monetary union, then one cannot dismiss it in considering the possibility of bailout of fiscally profligate national governments. (Note that all the criteria relate to the degree of economic and social integration, which seems to be gradually increasing in the case of Europe.)
- . What if the EC had skipped Stage II and gone directly to full currency union? Many economists say this would have been better, that the problem with the Maastricht lies in the transition period. It is true that, for certain medium-sized shocks, full currency union would be more likely to hold together than fixed exchange rates, because speculators could not substitute among the national currencies. But a sufficiently large shock would disrupt even a currency union if individual nationalities had not in their hearts and their votes made the necessary commitment, and the resulting disruption would be all the messier and costlier. (The current break-up of the Soviet Union is a good illustration.) There are some streams where one can leap across, and a wavering of resolve makes it more likely that one will fall in. There are other streams that are so wide that one cannot cross in a single leap no matter how determined, and one had better look for stepping stones along the way.