Dollars, Euros, and Debt

How We Got into the Fiscal Crisis, and How We Get Out of It

Vito Tanzi

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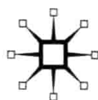

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Preface and Acknowledgments

During the most significant years when the euro was brought into existence and started operations, I had the privilege of being Director of the Fiscal Affairs Department of the International Monetary Fund, from 1981 until the end of the year 2000, and Undersecretary for Economy and Finance in the Italian government, from 2001 to 2003. In these positions I was in a somewhat privileged position to observe developments, especially in the public finance area, and to follow some of the decisions being taken on some relevant issues.

In the closing months of 2001, when preparations were being made for the introduction of euro bills and coins, to physically replace the national currencies of the members of the European Monetary Union, I chaired a multi-institutional committee, within the Italian government, that addressed some of the logistic problems that would be encountered when, on 1 January 2002, the Italian lira would no longer be the official money of Italy and would be replaced by the euro.

In the months that followed the physical change from the lira to the euro, I often had to meet representatives of consumer groups that, against all the statistical evidence available, kept arguing that the introduction of the euro had led to an enormous increase (a doubling they claimed) in consumer prices, thus making the Italians immediately poorer. Some questioned the exchange rate that had been used in the conversion from the lira to the euro. Others argued that the shops had taken advantage of the change in currency to immediately raise their prices. Still others argued that the introduction of coins, in place of the lira that had used only paper, had increased the weight in the pockets of Italians, forcing them to get rid of their coins more quickly, thus increasing the velocity of that part of the money supply. This relation between weight of money and its velocity was one that had not been theorized by economists!

These and other more or less absurd beliefs were held with great conviction, at times even by economists who should have known better. At the same time some individual members of the Italian

government, of which I was part, expressed an embarrassing ambivalence, or, occasionally, even open hostility versus the change that had occurred. The euro had not been welcomed by many groups and by some political forces that had continued to feel nostalgia vis-a-vis the lira and perhaps for the occasional devaluations that it had allowed. In the years that followed, the euro, born under a not-too-welcoming star, would continue to be accused of crimes that it had not committed.

After I left the Italian government, in July 2003, and returned to live in Washington, given my background and professional interests, I continued to follow the fiscal developments in major countries and in Europe and the European Monetary Union and to write articles, for newspapers or for more academic vehicles, on public finance developments in Europe and in the world.

Some of the material in this study was presented, in earlier and much shorter versions: at a seminar, given at the East India Club in London, on 16 April 2012, organized by Politeia, a British think tank located in London. After the seminar, Politeia published a pamphlet based on the lecture, which received useful comments from Dr Sheila Lawlor, the director of Politeia. This book has borrowed some of the ideas first presented in that pamphlet; at the "Consilium 2012" conference, held at the Hyatt Regency Coolum, North of Brisbane (Australia), on 24–25 August 2012, organized by the Centre for Independent Studies, an important Australian think-tank; and at a conference in Sestri Levante (Italy), on 6 October 2012, organized by the Istituto Bruno Leoni, an Italian think-tank. I wish to thank the organizers of these meetings for having given me the incentive to think about some of the issues discussed in this study, and ultimately for having given me the idea of writing this book.

I also wish to thank my son, Alexandre B. Tanzi, an economic reporter for the Bloomberg Network, for numerous discussions on issues related to this study, for helping me with some difficult-to-get data, and for making me aware of articles published by the Bloomberg Network that were relevant for, and used in, parts of this study. Discussions with George Iden, formerly from the IMF, and with Craig Torres, a columnist at Bloomberg News, on some institutional aspects of monetary policy, especially those concerned with monetary unions, were also useful. My thanks go to both of them, while any errors of interpretation remain with me.

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Finally, I must express my deep gratitude to my wife, Maria, a former IMF statistician, who, by discussing with me some aspects of payment systems and by, additionally, taking upon herself the full responsibility for running the house, was the perfect companion who created the ideal environment that allowed me to write this book in a short period of time.

Bethesda, MD VITO TANZI

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1
Introduction

The financial, economic and fiscal crises – the "Great Recession" – that rocked many countries in the years after 2007 have continued to influence the economic developments of several countries, especially but not only in Europe, and, within Europe, in the euro area. In some of their aspects, the crises have generated interesting and at times unexpected reactions on the part of both economists and policymakers. These unexpected reactions could be interpreted as reflecting intellectual flexibility on the part of some, opportunism on the part of others, and perhaps also continued optimism on the part of others still, with regard to the impact that particular policies can have on economies.

Discretionary, or *active,* fiscal policy – to distinguish it from the passive kind associated with the response of truly *automatic,* or *built-in, stabilizers* to economic fluctuations – was quickly resuscitated and promoted, at times with almost religious zeal, by a few vocal and well-placed economists and financial commentators, when the crisis came. Because of the strong criticism that that policy had received, especially during and after the decade of the 1970s (criticism that had earned Nobel prizes for some economists), discretionary fiscal policy had seemed to have lost some, even much, of its attraction, at least among academic economists. However, it had remained popular among politicians and economists working in international institutions, in some think tanks, and in most governments. This would have been obvious to anyone listening during meetings of the Executive Board of the IMF to the interventions of the Fund's executive directors.

At the very beginning of the financial crisis in late 2008, a strong, active fiscal policy, aimed at counteracting the effects of the financial crisis on the economies, had been advocated by some economists, including a number working in international institutions, including the IMF. For example, a paper issued by the IMF on 29 December 2008 had recommended the introduction by countries of an "optimal fiscal package" that should be "timely, large [and] lasting" (see Spilimbergo *et al.*, 2008). However, as time passed, the international institutions became aware of the medium-term consequences that such policies could generate and became more guarded in the statements that they made. They started to worry about the long-run effects of sustained fiscal deficits, in a context of relatively low economic growth, and especially about the consequences of the continuing growth of public debt that was taking place in many countries.

In Europe the impacts of the economic and fiscal crises soon got mixed up in the minds of some observers with the role and the survivability of the euro within the European Monetary Union (EMU), when the so-called "spreads" in interest rates (the differences between the interest rates paid by some countries and the rate paid by Germany) increased sharply and some of the members of the EMU started facing great fiscal difficulties when they saw the cost of their public borrowing rise dramatically, both compared with those of past years and compared with those of countries that at that time were considered fiscally safer. At that point, in the minds of many observers, the problem became the future of the euro, and less that of any specific countries that, especially when the countries were small, would not have attracted so much attention. The so-called *redenomination risk*, the risk associated with the reemergence of national currency – at least for some countries – grew, contributing to the increase in the risk premium that some countries had to pay. This risk influenced the operations of financial operators, including banks.

In this situation, several European countries that were members of the EMU soon discovered the limitations of *discretionary* or *active* fiscal policy, when they faced the unpleasant reality that, if their governments wanted to spend more money to fight the economic downturn than was available to them from their *ordinary* revenue sources, they needed the help of deep-pocketed creditors willing to extend to them the required credit, and at reasonable rates. Alternatively, they would need the proverbial assistance from "rich uncles"

(which in principle could be central banks or foreign governments or institutions) willing to provide the additional resources they needed for free or at reasonable rates. It is often forgotten that this reality can be constraining for both individuals and governments, especially when some policy tools, such as the exchange rate and the control over domestic credit expansion, are no longer in the hands of the national authorities, as had become the case for many European countries after they became members of the European Monetary Union and, on 1 January 1999, the eleven participating member states fixed their exchange rates permanently.

Several European countries, and especially those already in precarious fiscal situations before the crisis appeared – which included more countries than is generally believed – were soon faced with *high and rising* interest rates (with higher and growing *spreads vis-à-vis* the countries that were considered safe) on their public borrowing. This occurred in the middle of what, for some other countries, including Germany, the USA, and the UK, might have been considered a credit glut, because of the low rates that the governments of the latter countries needed to pay to borrow money. Interest rates that had diverged little among the EMU countries until 2007 and after around the year 2000, soon diverged significantly, returning to levels similar to those that had existed before the establishment of the eurozone.

In these circumstances, the economic and fiscal crisis, the Great Recession, was seen and experienced by many as a crisis of the euro, and not as a crisis of the individual countries in difficulties. Attention therefore shifted to how to save the euro. This led many observers, especially within the United States and the UK, to ask whether the common currency, which in previous years had been acquiring increasing prominence in the world's economy, and had slowly started to reduce the monopoly power that the dollar had had for decades as the world reserve currency, could survive the economic downturn and the crisis. This shift in emphasis led to a shift of attention towards different policies that presumably could save the euro.

Increasingly the question was asked whether belonging to the EMU, and thus losing the power that national governments generally have to inflate and to devalue their currency, had been a good deal for some of the EMU countries. The credit glut, which had created historically low interest rates for the countries that could benefit

from it, was largely the result of the expansionary monetary policies that some central banks had been adopting – policies adopted by the central banks to help some governments deal with the crisis and perhaps also the consequence of excessive saving rates adopted by China and some other countries. Additionally, once the economic crisis started, the reduced borrowing by the private sectors of the countries affected, because of the sharp falls in private investment and in consumption, also contributed to the credit glut in several of the countries considered safe. Before the crisis, China's willingness and ability to buy a large share of the public debt being created by the US government and, to a lesser extent, by some other countries' governments, had also had an impact on the interest rates (and on inflation). This had made the pre-crisis period one of "great moderation," when business cycles had been assumed to have disappeared from our world because of the potency of monetary policy and the wisdom of those who controlled it and when inflation and interest rates had been unusually low.

The policies followed by the central banks in 2008 and in later years sharply increased their balance sheets and helped provide a lot of liquidity to the countries, in the hope that it would help their economies. It also forced other countries to follow similar monetary policies. The low interest rates that the liquidity produced – for some countries – may have also reduced the urgency felt by their governments (especially in the USA, the UK, and also in Japan) to deal more aggressively with their own large fiscal imbalances and their fast-growing public debts. In the short run the burden of a public debt may depend less on its share of GDP, which is the statistic that attracts most attention, than on the cost of financing it, that is on the share of the interest payment in a country's GDP.

On the other hand, the high interest rates paid by the governments of the countries facing borrowing difficulties, several of which were within the European Monetary Union, made it difficult for them to maintain or promote an expansionary use of traditional fiscal policy, as some observers were pushing them, and have continued to push them, to do. The "spreads" between the rates paid by these countries and those paid by the "safe" countries increased dramatically and soon reached very high levels, and, for some countries, levels that were considered unsustainable over the medium run. Therefore, ironically, just when discretionary, expansionary fiscal policy might

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have seemed, at least to some observers, to be most needed by some countries, it became more difficult for those countries to pursue it, because of the lack of reasonably priced financing.

This was especially the case for several so-called Southern European countries, a group of nations that someone with a sense of humor denominated the PIGS, or, with the addition of Italy, even the PIIGS. Perhaps by coincidence, they were mostly Catholic countries, bringing back in fashion an old sociological theory, that Catholic countries tend to be less virtuous than their Protestant, or Calvinist, counterparts. Similar developments had been observed in several Latin American countries in the 1970s and the 1980s, in the transition economies of East Europe in the 1990s, and in some countries of Southeast Asia during the crisis in 1997–98. The crises in Argentina in 2001–02 and in Mexico in 1995–96 could also be included here.

This study will discuss some of these developments, especially in continental Europe but with frequent references also to the United Kingdom, the United States, or even Japan, which also have been experiencing high fiscal deficits and growing public debts but, so far, without the financing difficulties encountered by the continental European countries. In view of the ongoing debate about the role of fiscal policy during economic crises, the study will go back to the original formulation of the Keynesian fiscal policy, to highlight some of its often forgotten – or ignored – limitations. It will discuss the context in which the fiscal policy was originally formulated, by Keynes and by the early Keynesians, while identifying some of the implicit – but often ignored – assumptions of that policy. Perhaps, it should be mentioned that when we refer to Keynesian policies we do not necessarily refer to the thinking of Keynes himself but to that of the Keynesian school that developed in the late 1930s and the 1940s and that might not always have received Keynes's full endorsement; in some cases Keynes may not have considered himself a true Keynesian.

Some comparisons with the situation prevailing in that other *monetary union* that is the United States of America will also be provided. The reason is that it has been argued, by some well-known and influential economists, that the economic and fiscal problems in the euro area are the direct consequence of a faulty, initial design in the creation of the European Monetary Union, rather than of the misguided fiscal policies that were followed by several of its member countries,

especially in the years after the European Monetary Union was created, and that may have had little to do directly with the design of EMU. It will be concluded that the EMU and the USA are much more similar, as monetary unions, than has been assumed. However, the view that the euro's creation was "structurally flawed" may have influenced the behavior of some American hedge fund managers who may have been too quick to take positions that may have lost them or their clients much money.

Although this study is not directly related to the question of whether or not the euro will, or should not, survive, that question will inevitably have some bearing on the discussion. The basic conclusion will be that the problems now affecting several countries, and not just the countries that are members of EMU, have less to do with the initial design of the European Monetary Union and with the role of the euro, although these are likely to have played some role, and a lot more with the *sustainability of the level of public spending* in many of these countries, a level of spending that became increasingly difficult to maintain especially in a world in which financial capital can move freely in and out of a country. We shall, therefore, address the thorny and timely question of what realistic "exit strategies" the countries that are undergoing fiscal crises, and the countries facing potential future crises, could adopt, in order to reduce public spending and to escape from their current or future predicaments.

In the process the study will identify and present what could be called a *fundamental law of the growth of public spending,* a law that may help explain the level reached by the public spending of many countries in recent years. The explicit recognition of this law could play a significant role in developing policies aimed at reducing public spending over the medium and long run. It is always important to identify precisely the origin of a problem in order to deal with it.

The *fundamental law* is a law, or some may prefer to call it a *trend,* that, over the long run, has contributed to the large increase in public spending in many countries. It will be argued that the *increase* in spending has had less of a connection with the welfare programs that were initially introduced in many countries than is generally believed. It will be maintained that recognizing the law and reversing its impact can help with the exit strategies, while to some extent preserving the essence of the welfare states *in their original intentions.* It will be maintained that governments do not need to destroy

the welfare systems that were originally established in order to deal with the current crisis. They just need to make the welfare systems more efficient and better focused than they have been, by shedding some of the extra baggage that they have accumulated over the years since their creation. Whether the governments of the countries will be able to make the required reforms remains to be seen. However, in the view of this writer, some of the solutions suggested by various economists and some shortcuts, such as the financing of fiscal deficits by central banks, or, in the case of Europe, the creation of a "fiscal" or "transfer" union, will not bring a solution to the current problems. The solutions must come from the actions of the individual countries, with some potential, time-limited assistance from outside them.

The discussion of the exit strategy will be relevant also for countries that still find it easy to borrow at low rates, but that continue to have high fiscal deficits and growing public debts. These trends will eventually create problems for them, unless they are changed. These countries include Great Britain, the United States, Japan, and some others, where public debts continue to grow at fast rates and fiscal deficits remain high. If not reduced, the current fiscal imbalances of these countries are likely to lead, in future years, to unsustainable high public debts and to serious economic difficulties. It must be recognized that when the health of the patient becomes precarious, surgery may become necessary, and that surgery may possibly, but, one hopes, temporarily, make the patient feel weaker. Thus, the supposedly painless corrections advocated by some economists must be seen with skepticism. Many countries may no longer have the liberty to choose between austerity and growth but all countries have the options of removing structural obstacles to economic growth.

An additional problem to recognize is that, this time around, the level of public debt is high and growing not just in particular, individual countries but also *at the world level*. It is the public debt of the whole world that has gone sharply up, as a share of the world GDP. Furthermore, private debt has also gone up a lot in many countries, creating a strong need for de-leveraging on the part of the whole world. This may create a different reality from that in periods when the high debts were the problems of only some individual countries and some governments. In a world with economies that are much interlinked, through trade or financial relations, the high debts in

some countries, and especially in large ones, are likely to have major effects on the economic conditions in others.

For some countries (USA, UK, Japan), the change from the current and apparently comfortable financing situation they are now in to one with growing financing difficulty may not be gradual. History indicates that these changes are often not gradual. As happened in some countries in the past, say Korea and Thailand, in 1997, Mexico in 1982 and 1994, and Argentina in 2001, the change could be sudden and could come when it is not expected. It normally happens if, or when, creditors lose the trust that they have had in lending to countries' governments, while higher private borrowing, and perhaps rising inflationary expectations, begin to affect the nominal interest rate. Therefore, the relatively low inflation and the low interest rates that some of the countries have been enjoying so far (early 2013) should not be interpreted as signaling that their current fiscal policies can continue to be followed in future years; or that these fiscal policies can even be strengthened, as some highly vocal economists have kept arguing, in order to stimulate employment and economic growth. It could simply be the calm before an approaching storm.

Before leaving this introductory section, it should, perhaps, be reiterated that in the view of the author of this study, the current, major economic problem faced by many European countries is not that of the euro, or of how to save the euro. It is the more fundamental one that many of them, and not solely some of those in the European Monetary Union, over the years, have pushed their public spending to levels where it became progressively more difficult to finance it without increasing difficulties and without encountering major resistance either from taxpayers or from potential creditors. Without reducing the levels of public spending that have created difficulties, levels that may not be the same for different countries, because of different reactions to taxes, the countries of the EMU and of some other countries (including US, UK, and Japan) will not be spared the fiscal crisis that, so far, has focused the attention of many economists on the EMU and on the euro.

Fiscal crises are always more difficult to solve than financial crises, because they involve the role of many politicians and affect more citizens. The time may have come for basic surgery. Dealing with symptoms may no longer be sufficient. Of course this does not mean that the behavior of banks and other agents in the financial sector

has not played an important role. Financial liberalization has made it possible for some banks in some countries to make bad investments and at a level that would not have been possible when capital flows across countries were better controlled. This has clearly been the problem with the banks of Cyprus and of some other countries. In several cases the loans were provided to finance large public spending.

Finally let us imagine what might have happened if the European Monetary Union had not been there and every EMU country had attempted to deal with the financial crisis that hit all the countries with monetary expansion and with increased public spending. Are we sure that the results would have been better as some observers seem to imply? Are we sure that competitive devaluations and inflationary finance of fiscal deficits would not have followed? The euro may have imposed some coordination and discipline that would not have been possible without it.

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