MECHANISMS LIMITING PUBLIC DEBT'S PROPORTIONS AND THEIR APPLICABILITY IN THE EUROPEAN MONETARY UNION MEMBER STATES

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Abstract:
This paper aims at highlighting the content and functioning of the mechanisms limiting public debt's proportions, implemented through the public debt policy promoted in the contemporary economies, with direct applicability to the Member States of the European Monetary Union. The analysis reflects the possibility of using two alternative mechanisms, one based on the market discipline and the other on rules, although in practice these two are often applied simultaneously.

Key words: *public debt, market discipline mechanism, rules-based mechanism, European Monetary Union*

***JEL classification**: E62, G18, H63*

1. Introduction

The formation of public debt in the modern society is considered to be a normal and common result of the economical activity. When the government decides to consume or to invest amounts that are superior to the incomes obtained from taxes, there appears a budget deficit that needs to be financed, including by borrowing money from households and firms from the country and abroad, a case in which public debt emerges.

As long as it lies in acceptable limits, the formation of public debt can have positive effects from an economic and social point of view. They mainly appear from the practice of public loaning for the financing of certain increased investment expenses, which can be a determinant factor of economic growth and development and of complete occupation of the labour force.

On the other hand, when the public loan is excessively used, the unfavourable consequences become predominant. The over-indebtedness of the government generates adverse effects over the rhythm of economic growth, diminishing the consumption possibilities of the future generations, it increases the economic vulnerability and it reduces the possibility of the government to use the budgetary instruments in order to attenuate the impact of economic shocks, it determines the appearance of severe budgetary adjustments or, eventually, it leads to the repudiation of the debt through inflation or default, both having disastrous social and economic consequences.

In order to avoid the negative consequences that could appear, through the promoted public indebtedness policies, the governments have to seek the maintenance of the public debt under acceptable limits, though the implementation of certain specific mechanisms of control of its proportions. In the specialty literature, there are two alternatives presented for this situation: ***the limitation of the public debt through the mechanism of market discipline and the limitation through rules regarding the public indebtedness.***

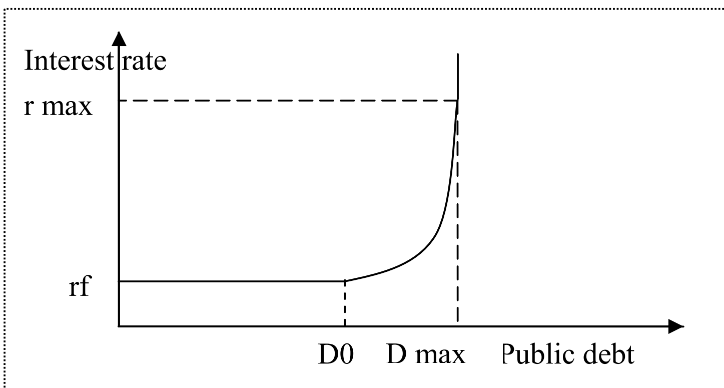
2. The mechanism of market discipline and the conditions for its effectiveness

The first mechanism is based on the action of ***the market discipline*** as a force that is able to limit the public debt abuse. It supposes that "financial markets provide appropriate signals and constraints to induce borrowers (both private and public) to behave in a manner consistent with their solvency" [Lane, 1992].

If the governments promote excessively the public indebtedness, with a possibility to exceed the supportable level, the potential investors in public securities will first answer by soliciting a higher interest rate, because of the inclusion of an increased risk premium corresponding to the increase of the default risk. If the increment tendency of the public debt continues, the risk premium also increases, with a growing rate, and eventually, the respective country is refused the access to the supplementary financial resources. The increase of the financing costs, together with the threat of exclusion from the financial market, could represent a stimulant for the "self-correction" of the irresponsible behaviour of the governments regarding the promotion of the public indebtedness.

The specified argument is graphically represented in figure 1, which shows the relation between the interest rate, the offer of funds put at the disposal of the government and the increase of the public debt size.

Figure 1: The impact of public debt's proportions on the interest rate and the offer of funds at the disposal of the government



Source: adapted after Lane, 1992

If the public debt is relatively reduced from the dimensional point of view, the creditors are willing to loan the state funds at an interest rate without any risk (rf). Beyond a certain level of public debt (D0), the creditors notice the possibility for the state not to have sufficient incomes to honour its commitments and they solicit a risk premium corresponding to the entered default risk, reflected in an interest rate that is superior to rf. As the state continues to borrow money and the public debt grows, the default risk is exponentially increased and therefore, the interest rate solicited by the creditors exponentially increases as well.

This thing happens up to the point in which the public debt reaches a maximum level (D max) as well as a maximum interest rate (r max), beyond which no supplementary increase of the interest rate could compensate the increase of the default risk, so that the issuer has no more supplementary loaning funds. In other words, at this point the debtor is effectively excluded from the financial market. But, a good functioning of the mechanism involves the fact that this situation does not emerge, as the governments respond in time to the signals issued by the market, correcting the size of the public debt, in order to avoid a crisis situation.

The market discipline mechanism can prove to be effective in limiting public debt's proportions, but for this to happen at least ***four conditions*** must be fulfilled [Lane, 1992].

a. The financial markets have to be free and open

The respecting of this request is necessary to ensure that an increase of the default risk associated to the growth of the public debt is translated through an increase of the interest rate of the loan made by the state.

First of all, this condition involves a situation in which the governments have no access to privileged financing sources or, in other words, there should be no captive market for the public securities, where the holders of money resources have no possibility to place them as private securities. The privileged access to the financing resources can also have other forms, like that of direct financing from the central bank or the different fiscal treatment of the incomes generated by the holding of public securities [Balassone, 2004a], affecting the effectiveness of the mechanism of the market.

Secondly, the condition involves the elimination of the control over capital movements that, if it is efficient, it could allow the governments to raise the public debt without determining a raise of the interest rate, by limiting the possibility of the holders of money reserves from the country to look for placing alternatives outside.

The liberalization of the capital account and generally speaking the liberalization of the financial markets is, therefore, the first step to ensure the effectiveness of the market discipline in preventing the promotion of unsustainable public debt policies.

b. The creditors must have free access to all the relevant information for the evaluation of the financial situation of the state

This condition involves the fact that the information regarding the public debt is freely available, correct and complete. It proves to be quite difficult to accomplish, seen that the methodology of commensurability of public debt itself often excludes certain forms of indebtedness or some governments hire financial obligations that are not reflected by the official statistics regarding the size of the public debt.

The evaluation activity developed by the rating agencies (such as Standard&Poor's, Moody's or Fitch-IBCA) could help the investors obtain information about the financial situation of the debtor state. Despite all these, as some authors underline [Balassone, 2004a], the rating accorded by these slowly adapts itself to the deterioration of the financial situation, so that it does not allow a corresponding increase of the financing costs.

In the context of the financial globalization phenomenon we nowadays witness, the indebtedness of the governments on the international financial markets demand – in order to ensure the free and complete access to information – the accentuation of the cooperation efforts in the collecting and dissemination of relevant data regarding the size of the public debt.

c. The bailout of the governments in distress must not be allowed

This request is the most important and its inobservance is the main cause of the failure of the market discipline mechanism. As about the public authorities, it is hard to accomplish because of the important role it plays in providing public services and goods that are essential for the society. To this, it is added the essential role played by credibility: the promise that in case of financial difficulties there will be no intervention for the rescue of the public entities is not enough, there has to be a conviction from the participants on the market that this intervention will not produce. Otherwise, the interest rate will not increase because of the increase of public debt and the market mechanism will have no efficiency in avoiding the over-indebtedness.

d. The government must answer the signals offered by the market through the interest rate

According to this request, the government must act as a rational agent, answering to an increase of the interest rate by reducing the public debt, so that it ensures its sustainability. In fact, taking into account the volume of information they hold, the public authorities should actually be able to anticipate if the supplementary debt will lead to an increase of the interest rate and, in this case, to give up from the start to the contracting of certain loans that would determine an unsustainable increase of the public debt.

If any of the four conditions mentioned above is not accomplished, the signals offered by the market can appear too late and the perception of the participants regarding the size of the public debt could suddenly modify, with disastrous consequences.

Although the state must take all the necessary measures to ensure a good functioning of the market mechanism, the difficulty of accomplishing the requests it claims if the debtors are represented by public authorities imposes the substitution of its deficiencies by ***establishing certain rules regarding the public debt***.

3. The rules-based mechanism

The mechanism based on rules involves the establishment of numeric limits or targets regarding the size of certain budgetary indicators. In certain countries, the limits are established by law, constitution or even international treaties, while in other countries they are the result of the budgetary procedures.

In order to prevent the unsustainable increase of the public debt, there can be taken into consideration rules that limit directly the level of the public debt or rules that refer to its control by limiting the size of the budget deficit as a main generating factor. The rules refer to the global size of these indicators or to their component elements that are often expressed as proportion of the gross domestic product (table 1).

Table 1: The major types of rules concerning budgetary indicators

Balanced-budget or deficit rules	• Balance between overall revenue and expenditure (in other words, prohibition on government borrowing) or limit on government deficit as a proportion of GDP • Balance between structural (or cyclically adjusted) revenue and expenditure or limit on structural deficit as a proportion of GDP • Balance between current revenue and current expenditure (in other words, borrowing is permitted only to finance capital expenditure)
Public debt rules	• Limit on stock of gross (or net) public debt as a proportion of GDP

Source: adapted after Kopits,1998

In practice, the quantitative limitation of the stock of public debt is seldom met, more often the limits referring to a direct control of the size of the budget deficit. This happens because the stock of public debt reflects the past decisions of the public authorities, decisions that cannot be modified anymore, while the size of the budget deficit is the result of the decisions form the current year. Even more, it is considered that the restriction of the public debt could exercise pressures over the governments, especially when the size of the debt is close to the maxim limit; in such a moment the necessary correction could be too important to be achievable and the restriction itself would not be credible anymore.

On the other hand, the control of the size of the budget deficit can prove to be inefficient in limiting the proportions of the public debt when the used measure of the budget deficit is not all-inclusive or when other factors play a very important role in the accumulation of the public debt. At the same time, if the rule regarding the budget deficit is defined as a maxim limit, the establishment of a cautious limit of the public debt could avoid the situation in which the deficit is permanently maintained close to the admitted maximum value. Therefore, in such situations, it is better that the limits regarding the size of the budget deficit are accompanied in practice by limits regarding the maximum level of the public debt.

In federal states as well as in the highly decentralized countries, the appeal of public debt is generally allowed to the public authorities at any level. In this case, the inferior public authorities are subject of restrictions regarding the size of the budget deficit, established by law or resulted from the budget procedures. The established rules generally limit the total size of the budget deficit and admit indebtedness only for certain purposes, most often for public investments.

The existence of rules concerning budgetary indicators can be found in many countries, as the examples in table 2 indicate.

Table 2: Rules concerning the size of budgetary indicators – selected countries

Country	***Target or ceiling***	***Period***	***Level of government***
Canada	Overall balance or deficit limit	Since 1993	Subnational governments
Germany	Yearly current balance	Since 1949	Federal government and subnational governments
Great Britain	Yearly current balance Net public debt limit (40% of GDP)	Since 1998	Federal government
New Zealand	Medium-term operating balance	Since 1994	Public sector
USA	Yearly current balance	Various	Subnational governments

Source: Kopits, 1998 and national authorities

The existence of numerical limits concerning the size of budget indicators must be supported by institutional or procedural rules to ensure the transparency of the budget process, the existence of monitoring and reporting systems. At the same time, adherence to these rules must be ensured by implementing a system of constraints, based on reputational, legal or financial sanctions. Although the sanctions in themselves are important, it is also important the way they are implemented. Institutions that monitor the compliance with rules must, in this perspective, have the effective power and capacity to ensure their implementation.

4. Applicability of the mechanisms limiting public debt's proportions in EMU Member States

Maintaining public indebtedness within acceptable limits and, most generally, the soundness of public finances, plays a unique role in a currency union, such as the

European Monetary Union. First, these are essential conditions for ensuring price stability, promoting sustainable economic growth and maintaining an equitable distribution of the costs and benefits of the monetary union. Secondly, considering the lack of independence of monetary policy as the competences are shifted to the European Central Bank, the budgetary policy instruments remain the only instruments available to national authorities for mitigating the impact of various economic shocks, and the government's over-indebtedness would exercise constraints on their use.

The possibility to rely on market discipline in limiting the proportions of public debt has been taken into account by the EU Member States when defining the conditions to be met by a country in order to adopt the euro. But at that time it was considered that although, to some extent, market forces could exert disciplinary constraints, the international experience in government defaults suggested that the "constraints imposed by market forces might either be too slow and week or too sudden and disruptive" [Committee for the Study of Economic and Monetary Union, 1989]. Therefore, the imposition of rules was seen as a necessary supplement to the action of market forces.

Reconsidering the applicability of the mechanism of market discipline in view of the present state of affairs in EMU Member States leads to the conclusion that, although progress has been made, the sole relying on coercive market forces in limiting public debt proportions remains problematic. The still limited applicability of market discipline in Europe is noted by the FitchRatings agency, in the report "Europe's Stability and Growth Pact: picking up the Pieces," which notes that it is unlikely that financial markets provide a powerful incentive for sovereign issuers in the euro area to maintain budgetary discipline, since "a euro-area government whose budgetary position weakens is likely to pay more for its debt, but the extra cost will be small"[Balassone, 2004b].

This situation can be explained, from the perspective of the criteria identified by Lane, by the failure to fully respect the conditions imposed to ensure the effectiveness of the market mechanism. Privileged government access to financial resources has never been a problem, as a result of the liberalization of financial markets, the prohibition of monetary financing of budget deficits and the ensuring of the European Central Bank's independence. An unsolved problem still remains that of the information available on the EMU Member States public finances, although their quality was much improved as a result of the statistical reporting requirements imposed by the Treaty of Maastricht and the Stability and Growth Pact. Equally, the lack of credibility of the commitments not to bail-out troubled governments remains an open issue, particularly in the countries with significant public debt levels and playing a major on the European financial market.

The mechanism of controlling public debt proportions in the EMU Member States remains, therefore, ***a mechanism based mainly on rules***. These rules both concern the size of public debt and budget deficit.

The Treaty of Maastricht, signed in 1992, states, as conditions to be fulfilled for a country to adopt the euro, that public debt must be below the limit of 60% of GDP or, if this level is exceeded, it should decrease at a pace deemed satisfactory and the budget deficit must not exceed 3% of GDP, unless exceptional circumstances are registered.

By the Stability and Growth Pact, drawn up in 1997 and reformed in 2005, the same rules are imposed to all the member countries of the Economic and Monetary Union, adding the target of a budget position close to balance or in surplus in the medium term. To ensure compliance with those rules, the corrective arm of the pact provides, through the Excessive Deficit Procedure (EDP), a wide range of measures, from recommendations to fines imposed to the states which refuse to comply with.

Table 3: General government gross debt in EMU Member States, 1999-2009

Country / Year	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008**	*2009**
Belgium	113.6	107.8	106.5	103.4	98.6	94.3	92.1	87.8	83.9	86.5	86.1
Germany	60.9	59.7	58.8	60.3	63.8	65.6	67.8	67.6	65.1	63.4	63.2
Irleand	48.1	37.7	35.5	32.2	31.1	29.4	27.3	24.7	24.8	31.6	39.2
Greece	102.5	101.8	102.9	101.5	97.8	98.6	98.8	95.9	94.8	93.4	92.2
Spain	61.5	59.2	55.5	52.5	48.7	46.2	43.0	39.6	36.2	37.5	41.1
France	58.2	56.7	56.2	58.2	62.9	64.9	66.4	63.6	63.9	65.4	67.7
Italy	113.7	109.2	108.8	105.7	104.4	103.8	105.9	106.9	104.1	104.1	104.3
Cyprus	58.7	58.8	60.7	64.6	68.9	70.2	69.1	64.6	59.5	48.2	44.7
Luxembourg	6.7	6.4	6.5	6.5	6.2	6.3	6.1	6.6	7.0	14.1	14.6
Malta	57.0	55.9	62.1	60.1	69.3	72.1	69.9	63.9	62.2	63.1	63.2
Netherlands	61.1	53.8	50.7	50.5	52.0	52.4	51.8	47.4	45.7	48.2	47.0
Austria	67.2	66.4	67.0	66.4	65.4	64.8	63.7	62.0	59.5	57.4	57.1
Portugal	51.4	50.5	52.9	55.5	56.9	58.3	63.6	64.7	63.6	64.3	65.2
Slovenia	24.3	26.8	27.4	28.1	27.5	27.2	27.0	26.7	23.4	21.8	21.1
Finland	45.5	43.8	42.3	41.3	44.3	44.1	41.3	39.2	35.1	31.6	30.2
Eurozone	71.6	69.0	68.0	67.8	69.1	69.5	70.0	68.3	66.1	66.6	67.2

* data for 2008 and 2009 are forecasts of the European Comission

Source: European Comission, 2008

However, as can be ascertained from the data presented in table 3, the efficiency of the rules proved, in practice, to be quite limited. Overall, the EMU Member States have registered significant public debt levels, exceeding in each year of the 1999-2008 interval the threshold of 60% of GDP. In some periods, the public debt of countries such as Belgium, Greece or Italy has been even higher than 100% of GDP.

This can be explained by the relatively low importance given to the criterion concerning the size of public debt and, especially, by the poor enforceability of the Stability and Growth Pact. As the threat to impose sanctions was not creadible enough, many countries, especially the very indebteded ones, continued to practice high budget deficits and to borrow money for financing them, even in favorable economic conditions.

Concluding, the need for budgetary rules in the Member States of the European Monetary Union has been confirmed in over a decade of its existence. However, for the rules to prove effective, their implementation is necessary to be made in a rigorous and consistent manner. In equal measure, improving the conditions for functioning of the market discipline in the EMU could complement the action of the rules-based mechanism in limiting public debt proportions.

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