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Excessive deficits: sense and nonsense in the Treaty of Maastricht

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This paper 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 EMU 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. 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 become '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 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 US? If a profligate country incurs a large debt, this will drive up the interest rate premium it must pay to compensate investors for the risk of default (see Goldstein and Woglom, 1992, and Alesina *et al.*, 1992b). 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 neighbours?

Including the reasons discussed by the authors with one or two of my own, 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 bail-out by central authorities, either fiscal or monetary. The authors emphasize that Articles 104 of the Agreement rule out bail-out, 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 who are of another nationality. This depends on the question of how much 'solidarity' exists among nationalities.

(2) There is the danger of spread of fiscal or financial crisis to neighbouring countries. The authors classify this difficulty as one of those that could lead to bail-out by monetization. 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 neighbours, notwithstanding that it had done a relatively good job of keeping its fiscal house in order. Similarly, 10 years later, Brazil is facing an inflow of capital along with its neighbours, 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 behaviour need not even be especially irrational.

(3) There is the much-analysed factor of macroeconomic spillover effects via interest rate and exchange rates. I fully agree with the authors' skepticism about the likelihood of policy-makers responding accurately to this problem.

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 towards excessive deficits. The authors sketch how this bias can arise. Given that the leaders had excessive deficits on their minds, what is the connection with 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. 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 behaviour. The institution would be a device for giving the national governments 'backbone', for reinforcing their political will to do 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.

The authors seem to see no reason why a fiscal commitment mechanism should be installed at the international rather than the domestic level. They mention the Gramm–Rudman–Hollings legislation and proposals for a balanced-budget amendment in the US as examples. The failure of these mechanisms at the federal level gives grounds for skepticism, and the authors list several reasons for worry, concerning issues such as the difficulty of monitoring commitments in the presence of accounting tricks. 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, 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 US East Coast as the perceived home of an elitist secret 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 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 neighbours. 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. If the monetary authorities respond to the will of the national constituencies, the crisis will occur in the foreign exchange market; if they do not, the crisis will take a political form.

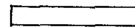
We saw these old truths illustrated in Europe in 1992. The shock was the German spending associated with the earlier incorporation of the Eastern Länder, and the crisis in this case occurred in both the foreign exchange and political arenas. In my view, Europe is fortunate that the shock came along as early as it did. The embarrassment and disruption would have been worse if the crisis had occurred during stage II.

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 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 USSR 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.

The tests of will that are 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 of will. They, even more seriously than a referendum, force the constituencies with 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 and claim his kingdom. Theseus' mother waited before even telling him 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.



[1] Among recent important contributions are Bean (1992), Begg *et al.* (1991), Eichengreen (19
Kenen (1992) and Wyplosz (1991).