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Is Debt the Achilles Heel of Europe?

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The history of European debt is a cautionary tale about the powerful inducements for households, companies and states to 'live beyond one's means'. This risk extends well beyond public finances into the role of the banks in potentially destabilizing credit and money creation. In this essay, Kenneth Dyson addresses this potential "Achilles' heel" of Europe.

The history of European debt is a cautionary tale about the powerful inducements for households, companies and states to 'live beyond one's means'. These inducements are long-standing, but they have grown with the level of financial and economic development that has accompanied the rise and spread of capitalism; with the intellectual illusion of financial control fostered by the prestige of the natural sciences; with the commercialization of social relations and the aspiration to share in the affluent society; and with the effects of greater political inclusivity and appeals to solidarity on public finances. In consequence, debt has become a greater risk factor both for European states and for the European integration process. This risk extends well beyond public finances into the role of the banks in potentially destabilizing credit and money creation.[1]

Is debt the Achilles heel of Europe? Can it be made safer? These questions need to be broken down into subsidiary questions. What kind of a problem is debt? Which and whose debt are we talking about? Do states have the will and capacity to ensure that creditors and debtors shoulder responsibility for their decisions? And can liability be matched by control?

What Kind of a Problem Is Debt?

Is debt a problem? The answer is likely to be negative for consumer junkies and hedonists. Otherwise, the answer is much less clear-cut. On the one hand, financial development and economic growth have gone hand in hand. Debt has provided a basis for investing and wealth creation. On the other hand, asset-price bubbles and busts, above all in property and housing markets, bear historical testimony to the dangers of debt. Excessive pro-cyclical credit creation, above all by banks, has led to recurring financial and economic crises. This duality suggests a distinction between 'good' debt, linked to investment in essential productivity-enhancing infrastructure, and 'bad' debt, above all linked to 'herd' behaviour in financial markets. This distinction formed the basis for the contrast between theorists of the

[1] This article was delivered as the Jean Monnet Annual Lecture at the University of Hull on Tuesday 5 May 2015. Those interested in exploring these issues in greater depth should consult Kenneth Dyson (2014), *States, Debt, and Power: 'Saints' and 'Sinners' in European History and Integration*, Oxford University Press, pp. 771.

developmental state (Alexander Hamilton, Claude Saint-Simon, Lorenz von Stein, and Adolph Wagner) and theorists of the self-binding state who gave primacy to firm, rule-based fiscal and monetary policies and tight controls of credit creation (the Austrian School, Thomas Jefferson, David Hume, David Ricardo, and Jacques Rueff).

We have come to see the problem of debt less in terms of social and political philosophy – as a test or signifier of moral character - and more as one amenable to numeracy. Literary understanding has given way to mathematical model building and technical, formulaic approaches to calculating sustainable debt. They have yielded presumably precise rules on deficits and debt and the probabilistic reasoning of credit rating agencies and markets. Two rules have gained prominence, if not notoriety: the Maastricht/Stability and Growth Pact 3% fiscal deficit/GDP and 60% public debt/GDP ratios; and the Reinhart and Rogoff rule of 90% public debt/GDP ratio before there are adverse effects on GDP growth. They have influenced prevailing debt narratives during the crisis as anchors for a certain kind of often concealed reasoning about what is the appropriate role of the state.

Notwithstanding this faith in numeracy and modelling, debt remains fundamentally a moral problem, amenable to different social constructions and posing hard value-laden choices. Its moral character is evident linguistically in the way in which debt and guilt are synonymous in the Germanic world. It finds historical expression in usury laws and in debtors' prisons. Fictional literature is haunted by debt: Balzac, Chekov, Dickens, Goethe, and Shakespeare for instance. The problems of distributive justice are unavoidable in addressing debt. How is one to balance burden-sharing between the reckless, the feckless, the gullible, and the innocent? Not least, debt is caught up in the problematic narrative of 'saints' and 'sinners', the latter applied more readily to the debtor than the creditor. Adam Smith sought to take refuge in the notion of the impersonal spectator. He rejected both the creditor's contempt for the debtor and the debtor's anger towards the creditor. Instead, Smith advocated organizing their relationship on the basis of respecting mutual dignity and honour. In this way, he pioneered the understanding of debt as a voluntary transaction between individuals seeking maximum utility, and not as a dependence relationship involving moral values

Which and Whose Debt Are We Talking About?

Three main risks face us in thinking about debt. First, emphasis tends to be placed on explicit debt rather than total liabilities. However, when one adds in implicit debt, notably unfunded social security liabilities like pensions and social care, public debt/GDP ratios look much more alarming. Seen in this way, public debt/ GDP ratios stand at well above 200% in Belgium, Britain, France, Germany and the Netherlands.

Secondly, debt is plagued by creative accounting, including hiding liabilities off balance sheet. Balance-sheet manipulation involves various accounting tricks designed to conceal liquidity and potential solvency problems. Their use extended from Greek public finances to American and European investment banks that were caught up in the sub-prime mortgage crisis of 2007-8.

Thirdly, debt is a composite problem of household, corporate (financial and non-financial), and public debt, with complex interdependencies. This insight matters in terms of narrative about the origins of the current financial, economic and sovereign debt crisis. In most EU

states and in the United States its origins lie in asset-price 'boom' and 'bust', with excessive credit creation and over-leverage, notably in the housing and property markets, and with subsequent costly and protracted deflation. Banks are vulnerable to household and corporate debt; in turn, public finances are vulnerable to banking crisis; whilst banks then become vulnerable to the crisis of state debt because of their holdings of sovereign bonds. The outcome is a potential deadly mutual embrace of banks and sovereigns. European banking union was a belated and partial effort to break this embrace by subjecting the major Euro Area banks to a harmonized asset-quality review, stress-testing them against adverse scenarios, and putting in place the rudiments of a cross-national bank resolution mechanism based on burden sharing. The crisis underlined just how pivotal bank lending was to the functioning of all parts of the economy and the state.

In thinking about the vulnerability of Europe to public debt it is important to bear in mind that we are talking about Member-State debt, not EU or Euro Area debt. The latter is a composite aggregate of Member State public debt. Hence Member-State public debt is potentially the Achilles Heel of the Euro Area; and hence the rule-based Stability and Growth Pact (SGP) and the fiscal compact treaty have been central to the architecture of monetary union.

The Euro Area was not designed as a European fiscal union in form of counter-cyclical stabilization mechanism with revenue-varying and expenditure-varying powers. For instance, it lacks a collective unemployment insurance scheme. There is also no collective debt issuance (Euro bonds), collective debt redemption in the case of legacy debts, and thus no collective debt management. Their absence reflects the fear of moral hazard: that Member States would have less incentive to take responsibility for addressing their fiscal and structural problems. It also reflects fears of a 'transfer union', in which the liabilities that would accrue to creditor states like Germany. However, the open question remains whether monetary union can be sustainable in their absence.

States' Power and the Financial Markets

States face enormous problems in supervising and regulating financial markets and in controlling how much banks lend and for what purpose. The problems include the size, technical complexity, and opacity of banks and their activities; the capacity to shift lending activity into 'shadow' banking; and the sheer speed of financial contagion in a digital world. Not least, the logic of the market is subverted once banks become 'too big to fail': profits in good times are privatized, losses in bad times are collectivised. However, the problem goes deeper: namely, the belief that banks will stabilize the economy, ignoring their crucial role in credit and money creation and its pro-cyclical character, leading to asset-price booms and busts.

The problems in supervising and regulating financial markets are exacerbated by collective action problems; states have incentives to defect in regulation and in tax arrangements in order the capture financial business. Also, digitalization and globalization of financial markets has led to a de-synchronization of market time and political time; markets move faster. This development has magnified the problem of 'animal spirits' in financial markets, the speed with which 'herd' behaviour bears down on states, making them vulnerable to

bouts of greed, fear and panic. This problem has taken on a bigger scale since John Maynard Keynes wrote about it in the interwar period. It is epitomized in the City of London and in Wall Street.

States have to grapple with the powerful instruments that financial actors possess. Financial lobbies generate and propagate dramatized stories of the negative macro-economic effects of closer supervision and tighter regulation, for instance of capital requirements and disclosure of information. Financial institutions practice regulatory and tax arbitrage, threatening to move to more amenable jurisdictions. Not least, they exploit opacity and creative accounting to conceal their lending activities. Banks do not simply lend money deposited by savers. They create deposits when they make loans, thereby expanding the money supply. This macro-economic aspect of their activity remains concealed from view.

In these circumstances of asymmetric power, states seek to insure against financial markets by relying on measures that will build market confidence in their credibility. One element in this confidence building is the privileging of certain investment banks as 'insiders' through the formalized Primary Dealer system. These banks gain special privileges in issuing and managing public debt. More politically visible has been the way in which states have come to rely on central banks as privileged intermediaries with financial markets. States have sought to build financial market confidence by making their central banks independent of politics. An example was the Blair government in the UK in 1997. However, central banks were far from independent of the financial markets. This mattered when banks played such a key role in credit creation and money supply and when central banks were being asked to play a more active role in supervising and regulating the banks.

Political Will and State Capacity

Political elites face powerful incentives to indulge debt, both public and private. A powerful combination of ideology, clientelism, and electoral strategy suggest a political business cycle, with competitive electoral politics pushing up fiscal deficit and public debt levels. More generally, governments are induced to tolerate expansionary credit policies to pacify publics, so that the lessons from asset-price booms are soon forgotten.

However, two qualifications are necessary. First, there is evidence that the same publics are politically averse to public debt accumulation, other than when a powerful and credible narrative of emergency helps shift attitudes, as with geo-strategic threat and war. Secondly, debt sustainability – and avoidance of default – does not correlate strongly with either Right-wing governments or with majority party governments. Both coalition governments (as in Germany and the Netherlands) and Left-wing governments (as in the Nordic area) are capable of delivering fiscal discipline.

A particular and pervasive problem is weak state capacity to use credit productively and to comply with fiscal rules. This problem is acute in much of southern - above all Balkan - Europe. It is manifested in clientelist politics and corruption, in large and expensive states that are poor at delivering public goods. In these cases debt sustainability becomes critical.

Debt and the Future of Europe

Against this background of vulnerability to debt dynamics, states need to create and be capable of enforcing powerful incentive structures to responsible behaviour by creditors and debtors. They also need to move away from 'one-size-fits-all' fiscal rules to a more contingent approach to insure against fiscal risks. The problems are not confined to the Euro Area. However, because of its asymmetrical design as a monetary without a fiscal union and because of its heterogeneous economic structure, more acute there. In the context of such heterogeneity, a 'one-size-fits-all' monetary policy of the ECB led to major differences in real interest rates in the first decade of the euro: too lax for Greece, Ireland and Spain and too tough for Germany. The result was inducement to excessive credit expansion in these states on the periphery of the Euro Area.

In general terms debt can only be made safer by structures and policies that enforce responsibility on reckless creditors and feckless debtors and, not least, strengthen controls on how much banks lend and for what purpose. Creditors need the discipline of tough risk-related rules on the quantity and quality of their capital, including rules on their holdings of sovereign debt. They also need the discipline of bail-in in time of bank crisis. Debtors need the discipline of conditionality-linked debt restructuring, enhanced financial literacy, and ending the preferential tax treatment of debt. But, no less crucially, protection has to be provided for the gullible and the innocent through consumer protection against mis-selling, legal liability on bank directors, and ring-fencing of certain expenditure programmes from cuts.

In the particular case of monetary union it will prove impossible to avoid both debt restructuring and the mutualisation of debt, at least in the long term. The Euro Area requires a counter-cyclical stabilization facility, with collective debt issuance, if it is to insure itself against economic and political threats to its coherence and survival. The lender-of-last-resort facility could include the transformation of the European Stability Mechanism (ESM) into a European Monetary Fund, an enhanced Single Resolution Fund, and a single deposit guarantee scheme within European banking union, as well as the ECB's active use of the OMT and QE programmes.

However, the mutualisation of debt raises difficult political and intellectual challenges, which cannot be met by current practices of stealth. First, independent revenue-raising powers and support for fiscal transfers requires a structure of European political union and a matching culture of political solidarity. It is far from self-evident that this will prove politically practical. Secondly, these developments depend on enhanced measures to deal with the attendant problem of moral hazard. These measures would include the financial sector through bank restructuring to address the 'too big to fail' issue, tougher capital rules, and bail-ins. They would also involve enhanced legal oversight of Member-State fiscal and structural reform policies. Fiscal as well as banking sovereignty would have to be transferred to the Euro Area. In addition, the ECB and its national central banks in the Eurosystem need to address the problem of bank credit creation and its potentially destabilizing role.

Finally, EU and Euro Area policy needs to recognize that debt sustainability requires more than just the Maastricht/SGP fiscal rules and the rules of the fiscal compact. It needs to assess Member-State fiscal buffers against a range of risks, which vary from case to case. They include geo-strategic vulnerability (given the association of war and debt in history),

exposure to sectors prone to asset-price bubbles (construction, finance), and the scale of implicit liabilities for instance in health, pensions, social care consequent on demographic developments. Fiscal buffers look dangerously small in relation to the current configuration of risks.

In the words of Jens Weidmann, president of the German Bundesbank, on 1 April 2015: 'Debt is like oxygen, indispensable for economic life, but when you overdose on it, you first get high, and then you faint.' The metaphor captures well the illusion, hubris and complacency induced by debt through the ages and its unhappy consequences. It accompanied the design and the early years of the euro. In the absence of great vigilance it will return.

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