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Europe Needs the Bond Vigilantes

By MARTIN FELDSTEIN

Spain's disappointing government-bond auction this week is a sign of things to come: If Europe's debt-bound governments won't get their fiscal houses in order, the bond vigilantes will descend, pressuring them to do so.

Europe's heads of state, however, still seem to think the solution is greater political unity not individual fiscal discipline. Indeed, 25 euro-zone governments are now engaged in ratifying a "fiscal compact." Its stated purpose is to prevent a repeat of the explosive increase of sovereign debts that can still threaten the solvency of those nations.

Sadly, there are so many weaknesses in the treaty that it will not be any more successful at preventing large budget deficits than the earlier Stability and Growth Pact that was quickly abandoned after its rules were violated by France and Germany.

The rapid growth of European sovereign debt can be traced back to the adoption of the euro in 1999. That shift to a single currency caused a sharp drop in inflation in countries like Greece, Italy and Spain. The lower inflation rates caused interest rates on their bonds to fall sharply. Governments responded to lower interest rates by borrowing more to finance expansions of their social programs.

The potential debt problem was compounded by households that seized the opportunity of lower interest rates to increase mortgage borrowing, creating a housing boom. When the bubble in house prices broke, the lending banks were in trouble. The governments in Ireland and Spain rescued those banks, greatly increasing their sovereign debt.

Amazingly, global financial markets were oblivious during these years to the rapid growth of those sovereign debts, treating all euro-zone sovereign debts as equally sound. Interest rates on the bonds of Italy and Spain remained only a few basis points higher than on German bonds until after 2009, when Greece revealed it had been understating its debt and deficits. Interest rates on the debts of several peripheral countries soon jumped to levels that, if sustained, would have implied national insolvency.

Those governments took policy actions that persuaded markets that their deficits will shrink and their ratios of debt to GDP will decline. The financial markets responded with sharp declines in their long-term interest rates. Italy's 10-year bond rate, for example, dropped to less than 5% from over 7%. But the high yields Spain was forced to pay this week in its lackluster bond auction have sent yields spiking across the region. Once again, the bond vigilantes have arrived to discipline euro-zone governments. The financial markets, as they should, will continue to focus on the size of individual sovereign debts and the likely paths of future deficits.

The euro-zone's key political leaders, led by German Chancellor Angela Merkel and French President Nicolas Sarkozy, have seized the crisis as an opportunity to advance the "European project," the goal of creating a political union that would give Europe a bigger role on the world stage. They decided to create a fiscal union as a step toward that goal. After fumbling with various alternatives, they agreed on

the current fiscal compact treaty.

It is in fact not a fiscal union with a combined taxing and borrowing authority like that of the United States. It would be described more accurately as a deficit-control agreement.

According to the treaty, every participating country must limit its "cyclically adjusted" budget deficit to no more than 0.5% of its GDP and must run fiscal surpluses until its debt is down to 60% of its GDP. Compliance with these limits will be judged by the European Court of Justice and fines imposed on countries in violation.

But what would it mean in practice? How would the critical "cyclically adjusted" deficit be measured? Consider Spain with a current unemployment rate of 23%, nearly double its level a few years ago. How much of its 6% budget deficit is cyclical? Spain could argue that its entire deficit is now due to its cyclical weakness and that it therefore has no cyclically adjusted deficit. Could a court really impose a fine based on rejecting this very ambiguous calculation?

With a current debt of 160% of GDP Italy should, according to the treaty, have a budget surplus of 5% of GDP if growth is stagnant and even more if it's declining. That much austerity would create a massive economic downturn, raising its deficit and debt. That makes no economic sense.

The treaty says that the deficit is to be measured "net of one-off and temporary measures." Wouldn't a countercyclical stimulus program of road building and cash transfers be considered to be one-off? Couldn't any public construction program at any time be called "one-off"? Shouldn't any government program that is not permanent be called "one off"?

The treaty also permits countries to deviate from the budget goal in "exceptional circumstances" and "periods of severe economic downturn." Certainly every European country can claim that today.

There is no reference to state-owned enterprises. Are debt-financed investments by state-owned public utilities to be counted as part of the fiscal deficit? They certainly wouldn't be if the same enterprise were privately owned. And where is the line to be drawn between public utilities and health-care facilities like public hospitals?

There is also no mention of the effect on the deficit of changes in nominal interest rates. With current debt levels, a one or two percentage point rise in the interest rate on government debt caused by a fear of future inflation would significantly raise current fiscal deficits.

The treaty will come into effect if just 12 of the 27 European Union countries ratify it, a low-enough hurdle to make its adoption virtually certain. Political leaders will claim that this is a major milestone en route to European political union. But it is really an empty gesture that will have no effect on future deficits and debts. Fortunately, the bond vigilantes understand this and are on the job.

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