This PDF is a selection from a published volume from the National Bureau of Economic Research

Volume Title: NBER Macroeconomics Annual 2015, Volume 30

Volume Author/Editor: Martin Eichenbaum and Jonathan A. Parker, editors

Volume Publisher: University of Chicago Press

Volume ISBNs: 978-0-226-39560-9 (cloth); 978-0-226-39574-6 (e-ISBN)

Volume URL: http://www.nber.org/books/eich15-1

Conference Date: April 17–18, 2015

Publication Date: June 2016

Chapter Title: Comment on "External and Public Debt Crises"

Chapter Author(s): Harald Uhlig

Chapter URL: http://www.nber.org/chapters/c13606

Chapter pages in book: (p. 257 – 267)

Comment

Harald Uhlig, *University of Chicago and NBER*

Introduction

This is a truly wonderful and remarkable paper. It concerns an issue of prime importance: What are the economic consequences of fiscal disruptions and fears of sovereign insolvency? And it also asks: Why do fiscal insolvency issues appear to be so devastating in individual member countries of the European Monetary Union or EMU, while they do not seem to have much of an effect on the private sector, when they arise in individual states of the United States of America? This is a great question, getting right at the heart of the matter.

The paper also throws in a comparison with Canada for good measure. Canada may be interesting, sure, and I can see that it provides yet a different set of possibilities. Its population is smaller than that of South Korea, for example, and it has about as many provinces: so, why Canada and why not South Korea? Or some other country of similar size? With all due respect to the Canadians: my guess is that only a rather limited amount can be learned about the functioning of the world economy and solutions to its various crises by observing Canada. I may be wrong. Nonetheless, I shall stick to the comparison of the EMU to the USA in my discussion.

The authors provide a detailed and remarkably well crafted, insightful, and detailed analysis of key episodes and their facts for the USA and EMU (and Canada, of course), combining it with a rather thorough analysis of the underlying legal issues: thorough and convincing certainly for this discussant, who confesses to a lack of expertise on these matters.

From these case-like studies, they draw the conclusion that the key difference lies in the legal structure. If Illinois or Puerto Rico or California

© 2016 by the National Bureau of Economic Research. All rights reserved.
978-0-226-39560-9/2016/2015-0303$10.00
This content downloaded from 198.071.006.043 on August 28, 2018 09:06:48 AM
All use subject to University of Chicago Press Terms and Conditions (http://www.journals.uchicago.edu/t-and-c).

goes bankrupt, they cannot impair private contracts and they cannot introduce their own currency. There is no private-sector fear of redenomination risk or large expropriation risk: taxes may go up a bit, but, in essence, the states are on their own. The situation is different in the EMU, where a Grexit, an exit of Greece from the euro zone, was discussed seriously and openly.

The authors follow up on the wonderful and fact-oriented analysis with a brilliantly simple (but not simplistic!) model-based investigation. The model is not complicated and its mechanics are not particularly surprising, once properly understood: the model simply is the perfect vehicle to clearly and cleanly lay out the issues at hand.

In the model, there is a benevolent government. The government as well as its citizens need to borrow in the first period. The citizens would borrow from some world financial market, while the government can choose to borrow from there or from its own citizens or some mix of the two. The government may face limits to taxation of its citizens in the second period. It may default on its repayment to its own citizens. It may default on its repayment to foreigners, and it may let its citizens default on their foreign debt. The authors consider various combinations of whether such defaults are allowed or limits to taxation exist. Any such default creates a fixed cost, possibly drawn at random from some distribution in the second period. Thus, if the choice is available, the government will compare that fixed cost to the utility pain of repayment in the second period and choose the default option, if that turns out to be more beneficial. All agents understand that in period one already, of course.

The "euro zone countries" case has all choices available to the government. It can freely set taxes in the second period as well as freely choose any of the default options. Given the freedom to set taxes, the government is able to arbitrage away any differential in borrowing costs that might arise between government borrowing from abroad and private borrowing from abroad. For example, if private citizens could borrow more cheaply, the government effectively lets them do that on its behalf, then taxing whatever it needs. If the second-period default costs are known in period one already, for example, there is a fixed limit on how much the government and its citizens can borrow. Due to the arbitrage considerations, the government and its citizens then act as if they were facing one common and overall borrowing constraint, rather than one for the citizens and one for the government. As a result, the

This content downloaded from 198.071.006.043 on August 28, 2018 09:06:48 AM
All use subject to University of Chicago Press Terms and Conditions (http://www.journals.uchicago.edu/t-and-c).

citizens face a constraint in borrowing from abroad precisely when the government does. This delivers the result that sovereign default fears in the euro zone countries case impair the private sector at the same time.

The "California" case for US states imposes limits on taxation, while also taking the option of private defaults on foreigners off the table. Now, the constraints are the constraints of the government only: due to its options to default in period two and due to its taxation limits, it now faces constraints on how much it can borrow in period one, while its citizens do not. There are no repercussions from sovereign default fears on the private sector.

This is a fine analysis indeed. It is terrific, insightful, useful, and deserves to be read and studied in many places. Indeed, it is highly accessible. By choice and design, this is not a high-wire act in economic formalism. Anyone with a decent undergraduate degree in economics or anyone with a bit of taste for logical and formal arguments should be able to digest this paper. I sincerely hope that many do so, beyond the narrow group of academics in their ivory towers. It is a transdisciplinary analysis of the best kind, combining economics with a discussion of judicial and historial matters.

In essence the authors argue that if only Europe had adopted a common, centralized legal framework like in the USA, much of the private-sector problems during the euro zone crisis would not have arisen! It would have been so much better, if enforcement of private contracts were enforced from some central euro zone government, and if that central government, moreover, strictly enforced the no-exit-from-the-euro rule.

This discussion would be incomplete if it only heaped praise on these fine authors. Let me then raise the skepticism that dictating common legal rules from a central government in Brussels or, for practical purposes, from Berlin really would be such a great solution for Europe. Anyone with a sense of history of Europe ought to entertain that proposal with considerable trepidation. This trepidation will provide the seed for my comments. But before turning to the details, let me take the liberty afforded to a discussant and get carried away for a bit, by commenting on a side issue in the conclusion of this fine paper.

Did Academics Anticipate the Euro Zone Crisis Ahead of Time?

In their conclusion, the authors remark that "When the member countries of the euro zone established their monetary union, neither aca-

This content downloaded from 198.071.006.043 on August 28, 2018 09:06:48 AM
All use subject to University of Chicago Press Terms and Conditions (http://www.journals.uchicago.edu/t-and-c).

demics nor policymakers anticipated that member states might experience external debt crises."

I disagree with that statement. Indeed, the Maastricht rules themselves were very much designed with the fear of an external debt crisis and its potential repercussions for the euro zone as a whole, in mind.

And there certainly have been plenty of academics worrying about the consequences of introducing a common currency and the resulting interplay with fiscal policy. As evidence, let me start with my own contribution here: while perhaps not justified in terms of significance, this is a choice all too tempting to this discussant. In 2002, I participated in a conference organized by a branch of the European Commission in Brussels on the challenges created by a common currency. The explicit aim was the information of and communication with the educated public, and not "just" the usual circle of academics present at our conferences. Put differently, politicians with responsibilities in these matters as well as quality journalists should be able to access these papers, and the hope clearly was that they would. The conference papers were published in a 2003 Cambridge University Press volume edited by Marco Buti, the current director-general for ECFIN. The volume includes Uhlig (2003), my own paper.

That paper devotes an entire section to "fiscal and monetary policy interaction: crisis scenarios." I shall confess that I wrote that "I believe that the European monetary union will enjoy good sailing in pleasant weather for a long time to come." Guilty as charged! But I continued by stating that

> it is the task of academics like me to point out what might happen when conditions worsen. The commanding officers on board of the European ship may do well to be prepared for a storm, may do well to be prepared for the worst, even if the worst never takes place. A scenario that is worth thinking through, and in which the potential for dramatic coordination failures between the independent fiscal authorities is great is a scenario of a fiscal crisis or a banking crisis in Europe. This then is the topic to which I shall turn now. . . .Citizens of Europe and the United States look upon banking and exchange rate crises—as, for example, those in Asia, Russia or Latin America in recent years—as they look upon Malaria or starvation: horrible events, to be sure, but certain that they will never take place at home. That complacency may be misguided. Crisis scenarios are hard to imagine in good times such as these: it is the ability of imagination that is now required of the far-sighted reader. Unsustainable fiscal debt build-ups in member countries may not be a concern today, but can one and should one really exclude that they ever will be? If so, what are the consequences? I argue that this scenario merits careful prior analysis. I cannot do more here than raise some of the issues arising.

This content downloaded from 198.071.006.043 on August 28, 2018 09:06:48 AM
All use subject to University of Chicago Press Terms and Conditions (http://www.journals.uchicago.edu/t-and-c).

And with that, I went ahead and tried to analyze the consequences. I shall confess that I did not have sufficient phantasy at the time to truly think through what would happen: for example, I never imagined that the ECB would so liberally interpret the no-bailout clause enshrined in the Maastricht treaty, as it has done.

But still: as far as this discussant is concerned, I certainly felt that I had duly tried to warn the public. And for that, I did not want to be considered a crank either, who constantly claims that the world will end tomorrow. Perhaps now you understand my introduction and, in hindsight, misplaced optimism. It was meant as a piece of analysis for those who, like me, felt it advisable to think through disaster scenarios ahead of time and when everything appears to be calm. The paper was discussed by Vitor Gaspar, then head of research at the ECB, and later finance minister in Portugal: a first-rate thinker and someone who, per officio, might surely have been deeply concerned about this issue. I have only the best things to say about him, but it is a fact that neither was there much echo or interest by the ECB research department for any follow-up on that topic, nor was there any echo by the educated public, that is, politicians in power or journalists of any stripe, for which the whole affair had been arranged. Zero. Nothing. Nada. What is an economist to do? Ram it down their throats?

I was not the only one: I am only reporting about my own case because I happen to know it particularly well. There have been plenty of warners and warnings, and with some effort one could produce a nice list of references, many of them misguided, to be sure, but others not. It was a fascinating mix of Kassandras and Quacks, and one could have spent some effort in sorting it all out. But the euro had been introduced and things seem to be working fine for now. Would the critics please shut up?

But then things did go wrong, in a remarkably short amount of time. With a heavy dose of sadness and cynicism, I have to laugh about the broad masses of utterly uninformed and clueless journalists out there, who, in their ignorance of what is actually going on in our science, proclaim that we economists have not thought about these issues ahead of time or other crises for that matter, and that we had failed to warn and to analyze before they arrive. One really should not take journalists particularly seriously, of course. It is their job to sell newspapers and news journals, nothing more. These are just one more form of entertainment, competing with Hollywood movies, YouTube videos, and the constant bombardment of Twitter messages. Serious investigative

This content downloaded from 198.071.006.043 on August 28, 2018 09:06:48 AM
All use subject to University of Chicago Press Terms and Conditions (http://www.journals.uchicago.edu/t-and-c).

journalism is expensive, and, it seems, in low demand by the public, paying for the newspapers that publish them (or, at least, paying for the products advertised in these newspapers). A journalist will much more easily entertain his or her readers by proclaiming a whole profession inept at doing its job. This assertion is assembled by essentially copying from other journalists, who have said exactly the same. This copying method, which appears to be so heavily favored by journalists these days, is cheap and assures that the journalist is in line with popular opinion and common views, since everyone is now saying the same. That does not make it any more true, of course, but it helps to sell the paper. And in a market economy that, really, is all that counts. I cannot complain about this equilibrium: I am merely pointing out its remarkable properties. Reasonably accurate information about the successes and failures of our profession is simply not what one should expect from journalists and their newspapers: that hope would be utterly misplaced.

In any case, we academics should surely not fall in the trap of repeating these journalistic assertions in the conclusion of an otherwise fine paper, as appears to be done here, and thereby giving them the appearance of a backing by serious scientists. They do not deserve it. And with that, let there be enough of this diatribe and digression, and let me return back to the paper. I just had to get this one off my chest.

Is It the Legal Framework?

Let me then examine the central claim of the paper: the difference between the EMU and the USA is the legal framework. The authors conclude that "the experiences of Canada and the United States indicate that stronger institutional foundations are needed to mitigate the risk of government interference with private contracts." What, exactly, is meant and implied by that? Let us think that through.

Let me contrast Greece to Illinois here: Puerto Rico or California may be a more appropriate example, perhaps, but Illinois seems to be reasonably close to bankruptcy, at the moment of writing, to serve well for the illustration. The population of Illinois and Greece is about the same, the GDP of Illinois is more than twice as high, while the debt-to-GDP ratio in Illinois is around 20%, compared to 160% for Greece. So, why is Illinois close to bankruptcy? It is indeed limited in its ability to tax: the bulk of taxation is federal, and too much of an increase in Illinois taxes may lead to an exodus of firms and citizens. For Illinois, its pensions

This content downloaded from 198.071.006.043 on August 28, 2018 09:06:48 AM
All use subject to University of Chicago Press Terms and Conditions (http://www.journals.uchicago.edu/t-and-c).

liabilities rather than outright government debt are looming large. The Illinois Supreme Court has decided that the Illinois Constitution thoroughly protects these pensions claims, since these benefits "shall not be diminished or impaired." Greece also faces considerable pension obligations, though they may be of lesser importance there relative to the situation in Illinois. Greek banks were once heavily involved in lending to the Greek government, and some of it is still happening, despite most of the Greek debt now being held by official lenders. In contrast, it does not seem that the issue of Illinois debt is of much concern to banks in Illinois.

According to the authors, Greece may interfere with the obligations of its citizens to foreigners, while Illinois cannot do so. I believe it is fair to interpret this difference to be about renumeration risk. Perhaps Greece exits the euro zone, reintroducing the drachma, and possibly additionally passing laws that all private debt amounts are now in drachma, rather than euros. There appears to be little possibility, on the other hand, for Illinois to leave the dollar zone and introduce its own currency. The difference, the authors argue, lies in the legal framework. Is that really it?

The US Constitution indeed does not permit Illinois to introduce its own currency, but neither does the Maastricht treaty allow this for Greece. There is no exit provision. Moreover, the Maastricht treaty together with the Stability-and-Growth Pact very clearly disallows bailouts of the Greek sovereign by the European Central Bank or other governments in Europe, and imposes a variety of fiscal limits with ensuing deficit procedures, should they be violated. These treaties nearly passed as part of a proposed European Constitution: despite the rejection of passing a constitution outright, they were regarded as constitution-like. As far as I can tell, the Germans actually believed that these treaties were law and would be followed. In actual practice, that turned out to be wrong. So, at the end of the day, I argue, it does not just matter what the Constitution or its European equivalent says: what matters is, how it is interpreted and enforced. The constitution, society, politics, and military options: they all matter.

To illustrate this, let me consider the hypothetical and arguably extreme scenario of an attempt by the government of llinois to exit from the dollar zone, and let me compare that to an attempt by the Greek government to exit from the euro zone.

It would all begin with Illinois declaring its debt and pension obligations as unbearable and "austerity" as nonoption. It might ask the

This content downloaded from 198.071.006.043 on August 28, 2018 09:06:48 AM
All use subject to University of Chicago Press Terms and Conditions (http://www.journals.uchicago.edu/t-and-c).

Federal Reserve Bank to buy Illinois debt and Illinois obligations to reduce its currently high yields. The Federal Reserve Bank would refuse. The Illinois legislature would then meet and introduce the "salamander" as currency (see Peter Greticos, "A Modest Proposal to Fix Illinois Finances," Feb 3, 2015, rebootillinois.com). It devalues, renumerating govermnent contracts, including pension claims. While they are at it, they decide to turn all federal taxes into Illinois taxes. They declare the Chicago Federal Reserve bank to be the new Illinois Central Bank (ICB). There would be a bank holiday and capital controls to prevent initial capital flight.

But that surely would not be the end. The US Supreme Court would declare the action by the Illinois government to be illegal and void. Negotiations between Washington and Springfield would ensue: suppose they fail. The US president would not allow Illinois to secede, however, and threaten military action instead. Imagine that Illinois remains defiant. Civil war breaks out. After many casualties, the union and status quo is restored.

Is that altogether impossible? It happened before. And it was a politician from Illinois, Abraham Lincoln, who eventually succeeded in enforcing the continuation of the union. Civil war is a constitutional crisis. It is not the text of the Constitution alone that matters. The Constitution, society, politics, and military options: they all matter. At the end of the day, it is the threat of civil war and military intervention, as well as the passionate resistance of the rest of the United States population to an Illinois exit, that prevents any serious politician in Illinois from even contemplating the dollar exit option, even if that logic is never laid out explicitly.

Let me compare this to an initially similar scenario in Greece. Suppose that Greece declares its debt as unbearable and "austerity" as a nonoption. It asks the ECB to keep buying its debt: indirectly per emergency liquidity assistance to Greek banks or explicitly, in order to reduce yields. The ECB may actually do so, and, indeed, has done so in the past. But now suppose this is not enough and that the Greek economic problems persist. Greece reintroduces the drachma. It devalues, renumerating government contracts, including in particular debt and pension obligations. There is no need to turn European taxes into Greek taxes: they were always Greek taxes to begin with. Greece already has a national central bank. Greece would declare a bank holiday and capital controls to prevent initial capital flight.

This content downloaded from 198.071.006.043 on August 28, 2018 09:06:48 AM
All use subject to University of Chicago Press Terms and Conditions (http://www.journals.uchicago.edu/t-and-c).

But that surely would not be the end. The European Constitutional Court would declare the ECB actions to be legal, but declare the Greek exit to be illegal. Suppose that European negotiations with the Greek government fail to reach a deal. The European governments threaten to cut off further funding. Suppose Greece remains defiant. European leaders declare that no one wants a war in Europe over this, and, secretly, breathe a sigh of relief. The Maastricht treaty gets rewritten. Greece exits, devalues and defaults on its debt. Impossible? Not at all.

The difference is not the legal rules or the decisions by the Supreme Court. The Constitution, society, politics, and the military option: they all matter. Precisely because everyone would agree that, at the end of the day, it is up to Greece to remain part of the euro zone or not, makes it possible for Greek politicians (or German politicans) to entertain the Grexit option seriously. And surely no serious politician in Europe would entertain the option of an inner-European war. Nobody wants to see German tanks rolling into Greece, enforcing some common legal framework. Europe was there twice already in the last century. These times were not remembered as a "civil war," in a telling contrast to the United States. This part of European history may be more important in explaining the differences in these crisis scenarios than the details in the texts of the constitution and treaties.

One does not have to go to this extreme to see additional differences emerging that have a lot more to do with the structure of the banking system and the role of the central bank, and only indirectly with the legal framework per se (though one might wish to argue that they are connected).

A less extreme, but still severe scenario might look as follows. Suppose the Greek government declares default, leading to disruptions of the Greek economy. The ECB stops its emergency liquidity assistance to Greek banks. The Greek banking system crashes. Capital controls are imposed. The ECB no longer accepts collateral from the Greek central bank. The Greek economy crashes. There will be lots of private defaults.

Contrast this with the initially similar scenario in Illinois. Suppose the Illinois government declares default on bonds and pension obligations. Unionized public employees go on strike over impaired pensions. The Federal Reserve bank, though, never purchased Illinois bonds in the first place. The Illinois banks are not particularly exposed to Illinois debt either. There would be no point in imposing capital controls. There will be few private defaults.

This content downloaded from 198.071.006.043 on August 28, 2018 09:06:48 AM
All use subject to University of Chicago Press Terms and Conditions (http://www.journals.uchicago.edu/t-and-c).

Conclusion

This wonderful paper took up an issue of prime importance: What are the economic consequences of fiscal disruptions and fears of sovereign insolvency, and why is the situation so different between the USA and the EMU? Based on a transdisciplinary investigation of historical and legal facts and economic logic, as well as a model-based analysis, the authors argue that the difference is due to legal matters: in Europe, governments may impair the ability of its citizens to repay foreign debt, in particular in case of an exit from the euro zone, while this is ruled out per the constitution in the United States.

This is an intriguing and insightful comparison: it invites thinking more about these issues, and so I have tried, in my comments. I have argued that one needs to go further than to look at the legal issues alone. The Maastricht treaty may not be so different from the US Constitution, in terms of calling for the common currency as a permanent solution.

However, it is not just the Constitution that matters. The Constitution, society, politics, and the military option: they all matter. As an example, an attempt of Illinois to secede from the union and to introduce its own currency would, in the extreme, lead to civil war in the United States. By contrast, an attempt by Greece to secede from the European Union and introduce its own currency may instead be greeted by a sigh of relief by some, with no serious politician even contemplating a war, civil or otherwise, to prevent this from happening. Legal frameworks matter. So does the societal consensus, the will and the ability to enforce them.

But these remarks are not meant to take anything away from this paper: they are meant to complement and extend the fine analysis there, and to broaden and deepen this important debate. It is a terrific, insightful, and useful paper indeed. It deserves to be read and studied in many places. By choice and design, the authors made it accessible to anyone with a decent undergraduate degree in economics or anyone with a bit of taste for logical and formal arguments. I sincerely hope that many take that option, beyond the confines of the academic ivory towers. The paper and the issues discussed deserve it.

Endnote

Address: Harald Uhlig, Department of Economics, University of Chicago, 1126 East 59th Street, Chicago, IL 60637, U.S.A; e-mail: huhlig@uchicago.edu. This research has

This content downloaded from 198.071.006.043 on August 28, 2018 09:06:48 AM
All use subject to University of Chicago Press Terms and Conditions (http://www.journals.uchicago.edu/t-and-c).

been supported by the NSF grant SES-1227280. I have an ongoing consulting relationship with a Federal Reserve Bank, the Bundesbank, and the ECB. For acknowledgments, sources of research support, and disclosure of the author's material financial relationships, if any, please see http://www.nber.org/chapters/c13606.ack.

References

Uhlig, Harald. 2003. "One Money, but Many Fiscal Policies in Europe: What are the Consequences?" In *Monetary and Fiscal Policies in EMU*, ed. M. Buti, 29–56. Cambridge: Cambridge University Press.

This content downloaded from 198.071.006.043 on August 28, 2018 09:06:48 AM
All use subject to University of Chicago Press Terms and Conditions (http://www.journals.uchicago.edu/t-and-c).