Underneath the Euro Crisis

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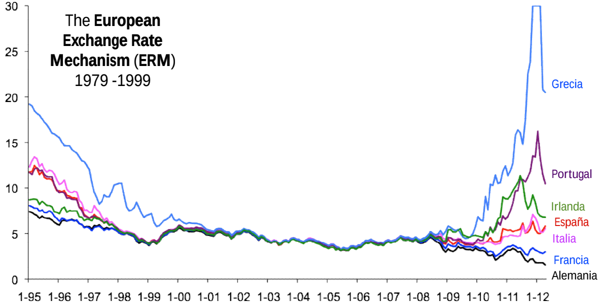
Interest rates on 10-year government debt



Fuente: *Thomson Reuters*

Questions for 2013

- Should a country join a currency union?
- Should a country exit a currency union?

Deeper Questions

- Should a government pay its debts?
- In a federal system, should a central government pay debts incurred by subordinate governments?

Should a country pay it debts?

- Reason not to pay: it is costly – taxes must be voted and collected.
- Reason to pay: you might want to borrow again. Paying existing debts fosters a good reputation among prospective creditors.

Should a central government bail out subordinate governments?

- Reason not to bail out: "moral hazard". Bailing out subsidizes subordinate governments' profligacy and creates incentives for them to want subsequent bailouts.
- Reasons to bail out: *quid pro quo*. In exchange for paying debts of subordinate governments, constitutions are restructured to give central government more control over activities of subordinate governments.

Distinct reasons to join a currency union

- By joining, foreign governments impose discipline that forces your government to balance its budget in a present value sense. "Italy is forced to behave more like Germany."
- By joining, your government expects foreign government to finance part of your country's domestic government expenditures. "Italians expect German tax payers to help fund Italian government expenditures and debts."

A good reason not to join a currency union

- To avoid discipline foreign governments may want to impose on your government's taxes and expenditures.

Two reasons to exit a currency union

- A fiscally profligate country may want to leave to avoid other governments' threats to impose discipline and control.
- A fiscally prudent government may want to leave to avoid having to bail out and/or to impose unpleasant discipline on other countries now within the currency union.

Components of a European fiscal union

Devices to draw lines between States and Union that

- Limit states' sovereign debt.
- Account for and limit liabilities of states' social safety nets.
- Prevent or limit socialization of bad private debts.

Components of a European fiscal union

Devices to draw lines between States and Union that

- Limit states' sovereign debt. Fiscal compact?
- Account for and limit liabilities of states' social safety nets. European stabilization mechanism? Conditionality?
- Prevent or limit socialization of bad private debts. European banking union?

Who chooses?

- Diverse groups of voters with conflicting interests within each country decide.
- Within and across countries, there are winners and losers.

Fiscal crises sometimes produce political revolutions

- French revolution.
- Second US revolution.
- Rewriting of state constitutions in the 1840s.