A FISCAL RESPONSIBILITY ACT FOR EUROPE

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The crisis shows that it is necessary to face the problem of "countries that are too big to go bankrupt"

The 2008 Global Crisis made it evident that there are banks "too big to go bankrupt". This is the key issue to be solved by the new regulation of financial markets. The 2010 European Crisis made it equally evident that the governments are too big to go bankrupt. A Fiscal Responsibility Act on the same basis as the one that has been in effect in Brazil since 2000 might be the solution to this problem. The 750-billion euro package announced by European governments last week surprised everyone by its magnitude and evidenced the resoluteness to defend their currency. If the most threatened countries implement the fiscal measures that are tough yet necessary to rebalance their fiscal accounts, it will be possible from now on to expect the overcoming of the crisis in the course of the following years (and provided that the issue of current account imbalance is solved as well).

The fiscal crisis was a consequence of the expansionist fiscal policy imposed on all countries by the 2008 Global Crisis. But such a fiscal policy would not have posed major problems had the public debt/GDP ratio in those countries been sound, had the level of debt not been dependent upon the creditors' willingness to roll it over indefinitely. That was not the case at all. In several countries, it hit around 100% of the GDP, when in fact half of that number is already excessive. Such high indebtedness rate seemed to be "under control", since the interest rate was very low. However, as the distrust of Greece emerged, the interest rate started to climb, the burden of the debt service increased, and the country became abruptly insolvent.

This crisis reveals the untenability of high levels of public indebtedness, as well as the softness of the European Union and the financial markets towards the issue. Whereas companies are required to maintain a high ratio between their cash flow and debt maturity, a substantially lower ratio between the primary surplus of each country (their cash flow) and their commitments in terms of interest and repayments is accepted. The reiterated balance-of-payment crises in developing countries showed that the assumption in which the financial market is based – the belief that "sovereign governments do not go bankrupt" – is false. But as far as the rich or nearly-rich countries are concerned, the financial market and government authorities have maintained their belief and accepted public indebtedness rates higher than 100%.

Now the crisis evidences that it does not suffice to solve the problem of "banks that are too big to go bankrupt"; it is also necessary to face the problem of "countries that are too big to go bankrupt". With the Maastricht Treaty, the European Union limited the public deficit to 3% of the GDP; it should have also established precise limits to the public debt/GDP ratio (the 60% limit was never enforced). By not doing it, the euro has become vulnerable. As a consequence, not only has it encouraged speculative attacks but also caused euro detractors to declare Greece's inevitable default and the failure of the euro project. It is too soon to come to such a conclusion. But it is also soon to declare the crisis over. The fiscal problem of the European Union countries must be solved in a conclusive way. And the path to achieve it would be something similar to what we performed in Brazil by enacting the Fiscal Responsibility Act in 2000. As such law set precise limits to the deficits and indebtedness of states and municipalities, their debt was restructured. Therefore, from that moment, everyone was able to abide by the new law.