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Different lessons For Europe from American financial history–a counterpoint to Mr. Gaspar*

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ABSTRACT

Sovereign debt restructuring played a key role in placing the US federal government on a sound financial footing under its new Constitution in 1789. State governments in the US, like national governments in the euro area, do not have bankruptcy protection. US state governments have not defaulted since the Great Depression, owing to a credible no-bailout policy by the federal government coupled with fiscal rules and an effective signalling of default risk by private markets. At the municipal level in the US, bankruptcy protections apply and recent default experience is very low. With permanent sovereign bailout mechanisms in place in the euro area, sovereign bankruptcy provisions might lessen officially induced moral hazard, allowing market discipline to function more effectively with respect to euro area countries than previously.

1. Introduction

In his article in this journal, Vitor Gaspar (2015) draws five lessons for the euro area from Alexander Hamilton’s efforts (1789–1795), as the first US Secretary of the Treasury, to place the new republic’s public finances and its financial system on sound footings. Two of those lessons are the focus of this paper. One, a case exists – based upon political, public finance, and financial arguments – to give priority to public credit. Two, the fundamental foundation of public credit is fiscal sustainability. These two lessons are intertwined in American history with applications to Europe. This first lesson, however, requires more nuance than provided in Mr Gaspar’s article. In particular, Hamilton’s debt restructuring – haircuts on domestic bondholders – in the 1790s made a significant contribution to laying the foundation at both the federal and state level for fiscal sustainability.

But there are additional lessons to be learned from US financial history. Some US states have found themselves unable to repay their creditors – notably in the 1840s, 1870s, and 1930s. Like euro-area states, US states cannot file for bankruptcy protection, but unlike euro-area countries, US states were not bailed out by the federal government and had instead to

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default on their bonds. Interestingly, no default by a US state has occurred since the Great Depression, owing to fiscal rules, a credible no-bail policy by the federal government, and effective market signalling of default risk. At the municipal level in the United States, although bankruptcy protection is available to state-chartered entities, their default rates have been very low. While not perfect, this incentive structure may have lessons for the design of institutions in Europe.

To begin, it is useful to summarise a few key facts from US history. After achieving independence from Great Britain in 1783, the United States was governed under the Articles of Confederation, which was a very different governance framework from the subsequent Constitution. Importantly, the Articles specified that, ‘each State retains its sovereignty, freedom, and independence and every power, jurisdiction, and right, which is not by this Confederation expressly delegated’. And very few powers were delegated. No executive or judicial branches existed under these Articles, which are unlike the EU; the confederation congress, where each state had one vote, only had the power to conduct foreign policy, declare war and sign trade agreements. Congress had no powers to tax or regulate interstate commerce including importantly banking, or issue legal tender/currency. Finally, the central government was saddled with debts to domestic and foreign creditors – estimated to be equivalent to nearly 29% of GDP in 1790 (Henning and Kessler 2012) – that were incurred to finance the war for independence. Not surprisingly given the lack of taxing authority, the new United States soon defaulted and its debts traded at a substantial discount.

The Articles of Confederation did not support an adequate fiscal policy or the public finances. Led by Washington, Madison, Jay and of course Hamilton (Ellis 2015), but reflective of broader forces and wider public debate (Maier 2011), a process was initiated to replace the Articles with the Constitution. While public finances in the United States in the 1790s were undoubtedly more precarious than current public finances in the EU or euro area taken as a whole, the US had one political advantage over the EU and euro area – the American people perceived themselves as having a common identity based upon a common language and largely common historical and cultural roots, and forged by a common struggle for political independence. Belief in a shared destiny coupled with a common identity underpinned a shift from confederation to a federal system that allowed national fiscal funding of national public goods and the national public debt.

2. Debt restructuring and fiscal sustainability

As Mr Gaspar stresses Alexander Hamilton’s (perhaps) greatest achievement was to regularise the debts incurred during the American Revolution by the Continental Congress and by the 13 states. Prior to the Constitution coming into effect (1789), these debts were in arrears and traded at steep discounts – roughly, 20 cents on the dollar. Regularisation was made possible by a two-prong strategy – (for details see Sylla 2011) consisting of: (i) a considerable strengthening of federal fiscal fundamentals that resulted from giving the federal government power to tax under the Constitution (while the American states retained their separate taxing powers); and (ii) a sovereign (federal) debt restructuring of the joint debts of the Continental Congress and 13 American states. The federal government assumed the debts of American states (equivalent to about 13% of US GDP in 1790), or an increase in federal indebtedness of nearly 50 per cent; similar action would be prohibited in Europe by Article 125 of the Treaty on the Functioning of the Economic Union.
As the first US Treasury Secretary, Hamilton laid out his strategy and rationale for debt restructuring in his first Report on the Public Credit (January 1790). In that Report, Hamilton argued that the debts of the 13 states ought to be assumed by the new federal government because those debts had largely been incurred to finance the American Revolution, securing its independence for the common good. But Hamilton had other motives too as he made clear later after leaving his post as Treasury Secretary. In his essay entitled, In Defense of the Funding System (July 1795), Hamilton noted that some American states (mainly in New England but also South Carolina) were heavily indebted requiring high taxes to service those debts, while other American states (mainly in the South, such as Virginia and North Carolina) were less heavily burdened. He worried that such high taxes might spark a taxpayer revolt, such as Shays’ rebellion of 1786 in Massachusetts. Hamilton was concerned that new taxes would ‘jeopardized [the government’s] popularity and gave a handle to its enemies to attack’. In addition, Hamilton was concerned that migration might be stimulated from high-tax states to low-tax states, which would only increase further the tax burdens in heavily indebted states.

Finally and perhaps most importantly, Hamilton recognised that under the new US Constitution, federal and state governments had similar taxation powers, except over import duties which were solely federal. He wanted to avoid taxation conflicts between the federal and state governments. Eliminating the debt service burdens of the states would lessen their need to impose taxes, allowing more room for federal taxation. As Hamilton put it,

To me there appeared but one way of untying or severing it [the Gordian Knot of our political situation], which was in practice to leave the states under as little necessity as possible of exercising the power of taxation. The narrowness of the limits of its exercise on one side left the field more free and unembarrassed to the other and avoided essentially the interference and collisions to be apprehended inherent in the plan of concurrent jurisdiction.

Under Hamilton’s plan, citizens in all the American states would shoulder the same tax burden in order to service their country’s debt. Thus, debt service rather than dividing the young nation could unite it under the new, and yet untested, Constitution. And assumption would make federal debt the sole benchmark for US credits, laying the foundation for a national bond market.

Assuming the debt of American states also meant that federal government could present a single plan to its creditors without the complications that would have been posed by different plans being put forward by the federal government and various American state governments. As Hamilton wrote, the United States as a nation would have been subject to ‘the weakness and embarrassment incident to fifteen or perhaps to fifty different systems of finance’. Hamilton would thus have a stronger negotiating position with creditors to the new nation by assuming the debt of all American states than otherwise would have been the case.

The debt service burden of the new United States was daunting according to Hamilton’s calculations. He estimated that the annual federal interest payments would be about $4.6 million compared to his estimate of federal governmental operating, or primary, expenses of $0.6 million. Thus, estimated annual interest payments for the federal government were more than 7½ times the estimated primary expenditures of the new federal government! (By way of comparison, annual debt service payments for Greece’s public sector were estimated by the IMF (SBA 2010) at about €13 billion in 2010, while primary expenditures were estimated at €104 billion; thus, Greece’s interest payments were about one eighth of its
primary expenditures. Federal tax revenues in 1790 totalled about $1.6 million, making interest payments by the federal government nearly 3 times higher than its revenues. (Meanwhile for Greece in 2010, the IMF estimated that interest payments by the public sector were only 15% of public sector revenues.)

Given the large federal debt service burden, it is not surprising therefore to find Hamilton observing in his first Report on the Public Credit that

The Secretary will not say that such [debt service] provision would exceed the abilities of the country, but he is clearly of the opinion that to make it, would require the extension of taxation to a degree, and to objects, which the true interest of the public creditors forbids. It is therefore to be hoped, and even to be expected, that they will cheerfully concur in such modifications of their claims, on fair and equitable principles, as will facilitate to the government an arrangement substantial, durable and satisfactory to the community.

It was Hamilton's view that by restructuring the consolidated public debt of the United States, it could be made sustainable both economically and politically, which also would benefit both creditors and the American taxpayer.

According to Hamilton's calculations, the total annual interest bill ($4.6 million) was divided into slightly over $4.0 million on domestic debt – held by Americans and denominated in continental paper – and somewhat under $0.6 million on the debt held by foreigners – mainly the Dutch, French and Spanish investors – and denominated in their foreign currency. In light of the relative small share of foreign debt (less than 15%) and a desire to secure access to foreign credit markets, Hamilton's proposed debt restructuring plan treated foreign and domestic creditors differently – a form of discrimination that would be witnessed in later sovereign debt restructurings across the globe. Foreign creditors would be repaid in full in their foreign currencies – 'according to the precise terms of the contracts' as Hamilton stated in his Report – including interest arrears. However, no interest would be paid on those interest arrears, which would produce a small savings – about 2% of the foreign debt. Hamilton intended to obtain new foreign loans at lower interest rates to repay the old foreign loans. This proposed more favourable treatment of foreign creditors was – somewhat surprisingly – widely accepted (Wright 2008).

Meanwhile domestic creditors could participate in a market-based debt exchange offer (Garber 1991). Old government debt, which could take various forms, such as loan office certificates, indents, notes, bills of credit and IOUs – would be converted into two types of new bonds. One bond – the 6s – would have a 6% coupon but interest payments would be deferred for 10 years, while the other bond – the 3s – would have a 3% coupon with quarterly interest payments. Interestingly, interest arrears on domestic debt would be converted at par into bond paying the 3% coupon, while principal would be converted at par but receiving the new bonds in a ratio of two-thirds for the 6s and one third for the 3s. Quarterly interest payments would be paid on time owing to new taxes on various 'luxuries', such as wine, liquor, tea and coffee. A sinking fund would underpin principal repayments. These elements accorded with Hamilton's view expressed in his Report that 'the creation of Debt should always be accompanied by the means of extinguishment'.

This exchange offer would reduce the net present value of outstanding claims on the US government by roughly one third – a creditor ‘haircut’ in modern terms (Sylla 2011) or debt reduction (Swanson and Trout 1992). This domestic creditor haircut helped, along with its new taxing powers, the federal government to achieve debt sustainability. In total, the net present value of federal debt was reduced by slightly over 25%, or 10% of GDP. A reduction
of 10 percentage points of GDP may not sound large, but it must be remembered that annual federal revenues were only about 2% of GDP in the 1790s (Sargent 2013). In a modern EU context, the equivalent ratio would be around 200% of GDP! This differential treatment of domestic (law) creditors compared to foreign (law) creditors was repeated in the 2012 Greek restructuring (Zettelmeyer, Trebesch, and Gulati 2011).

The plan for the assumption of state debt and treatment domestic debt holders – termed ‘redemption’ – encountered considerable opposition in the new US Congress, particularly from representatives from Southern states (Henning and Kessler 2012; Wright 2008). This opposition was rooted in their economic interests. One, Northern states had incurred relatively more debt than Southern states, reflecting the fact that the American Revolutionary War was primarily fought in, and paid for, by northern states. Moreover, for example, Virginia was aggrieved because it had already repaid a large portion of its Revolutionary War debt. Two, Northern speculators travelled to Southern states in the late 1789 and early 1790 to purchase government debt/IOUs, before word of Hamilton’s plan had spread there, taking advantage of veterans and their widows. As reported by Wright, non-residents owned three quarters of the debt/IOUs of North Carolina, South Carolina, and Virginia and the vast majority of those non-residents lived in New York, Massachusetts, and Pennsylvania. These speculators could be viewed as early vulture funds. To rein speculators’ gains, Congressman James Madison of Virginia – the chief author of the US Constitution – amongst others including Thomas Jefferson, championed a ‘discrimination’ approach that called for full payment only to the original note holder. The proponents of Hamilton’s redemption approach argued that discrimination would call into question the government’s commitment to honour the face value of its new bonds; that identifying the original note holders was not practical, and the old IOUs were recognised at time of issuance to be worth less than face value.

Debate over Hamilton’s funding plan lasted for almost seven months, providing speculators with opportunities to buy and sell. According to one historian (McDonald 1979), ‘Madison would put more profits into the hands of speculators than Hamilton’. It was precisely to avoid such speculative opportunities that Hamilton had urged Congress to act quickly. In the end, these arguments were not settled on their merits but through political compromise. Southern representatives and Senators supported Hamilton’s plan as part of the deal brokered to move the US capital from New York to Virginia and Maryland where the Potomac River serves as the boundary. Thus, the US Congress passed the Funding Act in August 1790. At that point, prices on the old domestic debt had risen to 60 cents on the dollar, likely reflecting perceived improvement in the prospects for repayment. Given the depth and speed of modern financial markets, this experience demonstrates the wisdom of making debt management including restructuring an executive function.

Passage of the Funding Act in August 1790 did not end this story. It only began what turned out to be a long drawn-out process for the voluntary debt exchange. On 1 October 1790, the US Treasury Department opened the new domestic debt to redeem various types of Revolutionary War obligations at different exchange ratios. The Funding Act envisaged that this exchange process would be closed after one year. However, holders of the old debt were slow to accept this offer, perhaps because they wanted to wait to learn how the financial market would value the new government bonds. By September 1791, only about half of the outstanding stock of old government debt had been converted into the new government debt (Sylla 2011), implying the other half were ‘holdouts’ to use a contemporary designation. Faced with this situation, the US Congress extended the period for accepting the exchange
offer. If the old domestic bondholders did not participate they would be paid as if they had subscribed to the exchange offer. This creditor treatment sounds very much like the approach taken by Argentina in the early 2000s!

In contrast to Argentina however, Hamilton had another sweetener to his debt exchange offer. Private investors could pay starting in July 1791 for shares in the federally chartered, but private, Bank of the United States, using gold/silver specie (one quarter) and new US government debt (three quarters). According to Sylla, Wright, and Cowen (2009), payment in US government debt increased its demand and market prices for federal debt rose from 70 cent on the dollar in December 1790 to slightly above par in August 1791. Higher prices on the new government debt – underpinned by regular quarterly interest payments and more liquidity – helped induce holdout creditors to participate in the debt exchange over time. By 1794, 98% of the old domestic debt had been converted into the new bonds. Still this process took some 3 years compared to the two months for the Greek debt exchange from formal offer in February 2012 to completion in April 2012 with 97% participation (Zettlemeyer).

While indeed a case exists to pay the public debt, American history also shows that debt restructuring can be an important element in a strategy to restore sovereign debt sustainability. Hamilton utilised haircuts on domestic private creditors to help the US government move from default status to fiscal solvency. Moreover, this haircut was equivalent to five times the federal revenues initially derived from the new Constitution! Clearly, debt restructuring made an important contribution towards placing the public finances of the federal governments on a sound footing.

3. Dealing with fiscal federalism – an American tale

As observed by Sargent (2013) in his Noble Prize lecture, fiscal federalism can lead to free rider problems between subordinate governments and the central government. In particular, he noted that subordinate governments – like states in the US and nations in the EU – couldn’t be relied on voluntarily to provide revenues to the central government to pay for public goods. In addition, it is a challenge for subordinate governments and the central government to sustain distinct reputations from one another for repaying their debts; this is a form of financial market contagion witnessed in both the United States and the euro area. Sylla (2014) draws similar lessons as Sargent from fiscal federalism in the United States for Europe. Rodden (2006) observes that when assessing a subnational government default risk, credit rating agencies must judge the probability and magnitude of a possible bailout from national government.

The move to the Constitution from the Articles resolved the first of these problems but not the second. Other developments in US financial history are germane to this second issue and also have relevance for the euro area. In 1793, the Supreme Court decided in one of its first significant early decisions (Chisholm vs. Georgia), that Mr Chisholm from South Carolina could sue Georgia for payment on goods supplied Georgia during the American Revolution. The Supreme Court ruled that Georgia had relinquished its sovereign immunity by approving the US Constitution. This ruling was effectively voided in 1795 by the ratification of the 11th amendment to the US Constitution. The 11th amendment gave sovereign immunity to the states making clear that individuals – domestic or foreign – cannot sue states unless the state consents, or waives its sovereign immunity. Today, this sovereign-immunity principle is valid globally, including within the EU.
In 1801, the US Congress passed its first bankruptcy legislation (under Article I, Section 8, Clause 4 of the US Constitution). However, American states were not covered by this federal legislation in accordance with the 11th amendment to the US Constitution. American states therefore cannot file for bankruptcy; they can however default and not make their scheduled debt repayments. The same is true for nations within the EU; they can default but they cannot file for bankruptcy protection. In 1801, this legislation did not have major credit implications because American states had virtually no debt since the federal government had assumed all their debts only a decade earlier.

Starting in the 1820s as the US expanded geographically and in population, development needs increased. With a lean federal government that did not engage in major infrastructure projects or ‘internal improvements’ as they were known then, American states therefore undertook massive investments – in canals, railroads, and roads – as well as in state chartered commercial banks. As these state fiscal deficits were driven by capital spending rather than current spending, they were viewed as prudent. According to Wallis (2005), American states employed two main techniques to promote internal improvements – special incorporation for banks and benefit taxation or ‘taxless finance’ for canals, railways, and roads. The debt was thus to be serviced by tolls without raising state taxes. This argument resembles the golden rule, discussed in Europe. With the success of the Erie Canal (1825), states issued similar bonds – backed by future revenue streams – that appeared to be solid investments. Investors may have also mistakenly believed that state bonds had the same investor protection as federal government bonds, or that the federal government would bail the states out as it had in 1790. They were wrong on all counts!

By 1836 American states had chartered over 600 banks, with an authorised capital of $480 million and paid in capital of almost $250 million. They invested at least $80 million in banks within their state borders. By 1838, governments of American states owed about US$ 172 million compared to only US$ 3 million owed by the US federal government! These states’ debt funded investments in canals (35%), private commercial banks (31%), railroads (25%) and miscellaneous other projects (9%). British investors owned about over three quarters of this debt.

These internal improvements were taken on an American state-by-American state basis. So far, this set-up is very similar to the EU today where most government investment is decided at the national level in the EU Some infrastructure projects in the EU are however financed by the European Investment Bank and EU structural funds. The European Commission’s budget relative to EU GDP is about the same size as the US budget relative to US GDP in the 1800s.

With the financial panic of 1839, the US economy entered a deep recession that lasted until 1843. In 1841 and 1842, 9 American states defaulted on their bonds or about one third of all states then in the Union (Grinath III, Wallis, and Sylla 1997). These American states petitioned the US Congress for a federal bailout or debt assumption, citing Hamilton’s debt plan, and arguing that a federal guarantee, while not explicit was implied (Henning and Kessler 2012; Rodden 2006). Congress decided against a bailout for reasons related to moral hazard and because these states’ debts were not incurred for the common good – as were Revolutionary debts – rather these debts were incurred for the individual good of a state.

Contagion to the domestic US banking system – along with the ‘doom loop’ between government debt and banks that occurred in Cyprus, Greece, Ireland and Spain in 2010s – was nonexistence in the United States in the 1840s because most of the debts of the
defaulting American states was held abroad, primarily in the United Kingdom, and not held by the commercial banks chartered by these same American states. Contagion in European financial markets from the debt defaults by American states to the federal sovereign debt of the United States did place however (Wright 2008); indeed the US government was effectively closed out of European financial markets from 1842 until 1848. Foreign creditors particularly the British and Dutch, also pressed the US government to make good on the debts of American states, arguing that there was an implied federal guarantee stemming from the Hamilton assumption (Rodden 2006). Indeed, concerns existed in government circles in Washington that another war with England – making it the third in the country’s short history – might result unless the federal government acquiesced to foreign demands to assume once again the states’ debts. In the end, the federal government – supported by the Congress – resisted these pressures to assume the debt of the American states, leaving the individual states to work out new terms with their creditors.

As American state legislation to finance internal improvements generally had bipartisan political support, the blame for the states’ financial crisis was generally place on poor institutional arrangements – or policy frameworks. Consequently, reforms to American states’ constitutions to restrict the issuance of debt were prevalent during the 1840s in states that had defaulted (see Wallis for details). American states generally adopted balanced (operating) budget amendments to their constitutions, or other provisions in state law, requiring balanced operating budgets. Capital projects – both expenditure and debt issuance – typically fall outside these balanced budget definitions, which thus are therefore in line with the ‘golden rule’ concept. Wallis provides statistical evidence that these reforms lowered significantly subsequent borrowing by states even after adjusting for default experience.

The 1870s saw another wave of defaults by States (9) on their debts. All the states were in the South and more than half of their debts had accumulated during the Reconstruction period after the US Civil War. Southern electorates regarded these new debts as odious and illegitimate because they were imposed by military governments (Henning and Kessler 2012). Eight southern states repudiated nearly all the debts acquired during Reconstruction. Not surprisingly, the federal government did not consider a bailout of these states to forestall repudiation.

During the Great Depression (1930s), a surprisingly few (4) states (out of 48) defaulted. By the 1930s, the no-bailout principle for state debts by the federal government was firmly enshrined. Since Arkansas defaulted in 1933, no American state has defaulted on its debts, although California, Illinois and Louisiana have come close. American states also refused to bailout their local governments during the Great Depression. Thus, nearly 2300 local governments defaulted on their debts by 1935. In response, the US Congress passed the Municipal Bankruptcy Act of 1937 that allowed American states to permit state-chartered public entities to seek federal bankruptcy protection – or what has become known as Chapter 9 bankruptcy.

What accounts for this long period (more than 80 years) without a defaulting American state? Two mutually reinforcing forces dominate. One, the legal requirement to balance (operating) state budgets, which was initially adopted by defaulting states during the 1840s, became more widespread over time (Garber 1991). Nonetheless, state debts – both nominally and when scaled by revenues or state income – have risen owing to accumulated capital project financing. States have also kept their operating budgets balanced by deferring maintenance expenditures, creating public–private partnerships, and by agreeing to contingent
liabilities entailing future spending for pensions and health care of public workers. Finally, the effectiveness on these rules varies from American state to American state and by whether one political party controls both the executive and legislative branches. Two, rating agencies and financial markets provide signals to state governments and their voters as regards the state’s perceived creditworthiness. Indeed, considerable differentiation exists in credit ratings for states and yield on their bonds. Excluding distressed cases, these yields have recently spanned about 200–300 basis points. Yet the yield on the average 10-year state bond in 2015 was about 275 basis points, or roughly the same as for US Treasuries. Several empirical studies (Bayoumi, Goldstein, and Woglom 1995) found evidence that for American states, US capital markets increase risk premia in response to deterioration of fiscal fundamentals. Also spillovers in bond markets for American state and municipalities have been judged not to be of the ‘contagion’ type, but of the ‘flight to quality’ type (Henning and Kessler). But as the subprime crisis in the United States has shown risk assessments by private markets can go badly wrong.

The municipal bond market in the United States is large – US$ 3.7 trillion of outstanding bonds – and diverse with 54,500 issuers. By comparison, the US corporate bond market was nearly twice large (US$7.8 trillion outstanding), but far less diverse (only about 5700 issuers). According to Moody’s Investor Services (2015), the 10-year average cumulative default rate for rated municipal bonds during the period 1970–2014 was 0.14%. The equivalent default rate for rated corporate bonds was 11.58% or more than 80 times more frequent. Thus, although municipalities in the US have recourse to bankruptcy protection similar to that available to US corporations, municipalities’ default behaviour related to their rated debt is much more like US states than US corporations. Available evidence shows that non-rated municipal bonds experienced 36 times as many defaults as rated municipal bonds during the period 1970–2011 (Appleson, Parsons, and Haughwout 2012), indicating that an effective selection/filtering process is at work.

In 2016, Puerto Rico, a US territory but not a US state, has missed payments on various types of its obligations, showing that the preventive forces of the US model discussed above are not foolproof. The US Supreme Court decided in June 2016 that the federal bankruptcy code does not apply to three public utilities of Puerto Rico that collectively owed US$ 20 billion. The legal question revolved around whether a US territory can permit its municipalities and other state-chartered government entities, such as public utilities, to seek federal bankruptcy protection under Chapter 9 as US states are allowed to do for their governmental divisions. Meanwhile, the US Congress approved in June 2016 an Obama Administration proposal to create a federal oversight board that would manage Puerto Rico’s budget for several years and bind in Puerto Rico’s creditors into as yet to be determined debt restructuring plan. Under this new law, no federal or state funds would be utilised to assist Puerto Rico. This legislation is not dissimilar in main elements from the proposal to establish a sovereign debt restructuring mechanism within Europe (Gianvati et al. 2010) and the role played by the E.C. in conditional lending to EU members. In both cases, a democratic deficit would ensue as local sovereignty is transferred to the union level, requiring a delicate balance be struck between political and economic issues.

4. Europe is different in practice

Under Article IV of the Treaty on the Function of the Economic Union, member states ‘shall not be liable for or assume the commitments of central governments …’ – the no-bailout
clause. This clause was underpinned by the Stability and Growth Pact with its preventive and corrective arms (e.g. the Excessive Deficit Procedures). Thus, these aspects of the EU architecture resembled at least formally the US legal construct. American states are not required to bail out other American states, nor is the federal government required to assist American states that are in trouble. Nonetheless, both the EU and US systems do not prevent voluntary bailouts or financial assistance of nations/states by their respective union level institutions or by their respective peers.

In practice however, the US and euro area have taken different paths in dealing with the financial crises faced by states/nations within their respective currency unions. As discussed above, a combination of fiscal rules and market forces backstopped by a credible no-bailout policy at the federal level, or bankruptcy provisions for municipalities, has worked successfully since the Great Depression. Distortions caused by official moral hazard in the bond markets for states and municipalities are largely absent in the United States, while in Europe, financial markets initially eliminated sovereign credit risk amongst euro area countries in part owing to the untested nature of the no bailout commitment and encouraged by regulatory and collateral rules (Buti and Carnot 2012). In this section, our focus will be on the implications of official moral hazard for the future operation of financial markets and further efforts to reform the euro-area architecture.

Prior to the euro crisis, financial market differentiation – as revealed by spreads – of sovereign creditors in the euro area was much less than the differentiation for American states. Empirical studies found the sovereign bond yields in the euro area were narrower than comparable bonds issued by US states and that the impact of fiscal variables on these euro spreads were statistically significant but small (Schuknecht, von Hagen, and Wolswijk 2010). As acknowledged by the European Commission (Buti and Carnot 2012) financial markets did not believe that the ‘no-bail-out’ clause of the Maastricht Treaty would hold when tested; perhaps, they had experience with the German Länder in mind. More generally, some empirical evidence suggested that default risk in the EMU was perceived by markets as “rather subdued” prior to the outbreak of the euro crisis and was “insufficiently high to prevent unsustainable national fiscal policies” (Afonso, Arghyrou, and Kontonikas 2015).

Empirical studies for German States (Länder) have generally found only very weak, or no, statistically significant evidence of rising risk premia with deteriorating fiscal fundamentals. The annual spread for Länder bonds over German federal bonds (bunds) averaged only 8–28 basis points during 1992–2007. These narrow spreads, or lack of market discipline, have been ascribed to moral hazard stemming from the 1992 bailout of two Länder (Saarland and Bremen). The German Federal Constitutional Court mandated supplementary federal grants to these two Länders based upon their high ratio of interest payments to revenues. Heppke-Falk and Wolff (2007) show that German financial markets did take account of possible additional federal grants as evidenced by the statistical significance of the coefficient on the ratio of interest payments to revenues. Schulz and Wolff (2009) analysed the impact on market credit risk of the 2006 German Court judgement rejecting Berlin’s claims for additional financial assistance. But at the same time, the Court confirmed the principles in its 1992 decision, implying that the interest payments ratio hadn't risen enough in Berlin’s case. The authors find that the Berlin ruling did not change investors’ risk assessments of German Länder. They concluded therefore that moral hazard – the market expectation of a Länder bailout by the German federal government – continues to prevail in the German sub-national bond market. Similar conclusion based upon empirical analysis can be found in Rodden (2006).
Comparing spreads on EU emerging market countries with emerging market countries elsewhere in the world during the period 1998–2006 to their respective economic fundamentals, Luengnaruemitchal and Schadler (2007) found empirical evidence that new EU members had systematically lower spreads – equivalent to about 100 basis points – below those for other emerging countries with similar fundamentals. They attributed this spread advantage to a “EU Halo” effect, which could stem from positive or negative factors. On the positive side, they cited improved policy frameworks associated with EU membership – acceptance of the *acquis communautaire* – and the prospect for euro adoption. Both would make this factor a lasing one. On the other hand, they opined that markets could “mistakenly perceive EU membership as providing some sort of guarantee against sovereign risk” or put another way, markets expected a EU bailout if these new EU members experienced a balance of payments crisis. In 2008–2009 in conjunction with the IMF, the EU did provide BOP assistance to three new EU members – Hungary, Latvia and Romania.

Within the euro area, the official sector gave some signals early after euro adoption that enhanced perceived moral hazard (Buti and Carnot 2012). For example, the ECB initially conducted its repo operations with government debt priced with zero credit risk, signalling an implicit “no defaults” stance (Boone and Johnston 2011). Later, the ECB introduced modestly differentiated credit risk haircuts. From the outset of euro adoption, EU regulation de facto granted a zero risk weight for euro banks on euro sovereigns (ESRB 2015). While this action may however have been (mistakenly) interpreted by the markets as an official signal (Boone and Johnston 2011). Both the EBSR/SSM and Basle Committee are now reviewing the treatment of sovereign risk by bank supervisors in part owing to the euro crisis.

With the outbreak of the euro-area crisis in 2010, bond yield spreads for euro sovereigns rose significantly and became more sensitive to fundamentals, which themselves worsen materially (Afonso, Arghyrou, and Kontonikas 2015); however, these identified fundamentals did not include actions taken at the euro-level to address this crisis. In particular, euro governments came to the financial assistance of 5 euro members – Greece (2010), Ireland (2010), Portugal (2011), Greece (2012), Spain (2012) and Cyprus (2013) – creating the European Stability Mechanism (ESM), while the ECB adopted extraordinary policy instruments aimed at these crisis countries (e.g. the Securities Market Program and Outright Monetary Transactions). The ESM and OMT were both challenged in courts as inconsistent with the TFEU, but the European Court of Justice denied these legal challenges, allowing these bailout tools to stand. Recognising its possible moral hazard implications and to reduce the scale of ESM financing, the ESM Treaty provides that ‘in exceptional cases an adequate and proportionate form of private sector involvement shall be considered’ – code words for a possible debt restructuring or bail-in of the private sector. In addition, a standardised collective action clause (CAC) became mandatory after 1 January 2013 for all new euro government securities with maturity above one year. CACs are provisions that facilitate debt restructuring by making easier for a supermajority of bondholders to bind legally hold out bondholders. However, the EU has not considered seriously the expert proposal to create a sovereign debt restructuring mechanism within the euro area (Gianvati, Krueger, Pisani-Ferry, Sapir and von Hagan). Experience with rated US municipal bonds under a bankruptcy protection regime indicates that a very low default rate is possible. Whether the perceived sovereign restructuring risk – increased *inter alia* by the Greek restructuring – will balance the perceived moral hazard in euro-area financial markets caused by official bailouts is difficult to determine at this time.
This empirical task is made more challenging at this time by the ECB’s dominate role in euro sovereign bond markets owing to \textit{inter alia} its asset purchase programme.

What are the implications of US history for the euro area going forward? The economic governance framework for US states relies on fiscal rules adopted at the state level and buttressed by financial market discipline made effective by credible no-bailout policy. The euro area also has fiscal rules, which were strengthened in response to the euro crisis, but these rules were imposed at the EU level rather than springing up from the national level with strong public support. These new procedures may still therefore succumb to pressures for peer protection at the EU level and more favourable treatment of large countries. Thus, official discipline may not have increased as much as suggested by these reforms. Prior to the euro crisis, financial market discipline over euro governments was weak, likely owing to officially induced moral hazard. Moral hazard forces may have been reinforced by official bailouts and the Draghi-put – a promise to do whatever is necessary to save the euro. Increased prospects for private sector bail-ins related to sovereign debt, such as took place with Greece, may partially mediate these moral hazard forces. Nonetheless on balance, it seems prudent to conclude that official and private discipline frameworks have not yet been sufficiently strengthened to avoid future crises in the euro area. To strengthen the private sector’s signalling role, the euro area needs to consider adopting positive risk weights for sovereigns, creating a sovereign bankruptcy code to substitute for official financial bailouts, and improving the information content of prices in sovereign bond markets by scaling back when possible, the ECB’s presence in those markets. The post-crisis euro architecture is not yet complete so choices remain to be made.

Notes

1. Hamilton proposed to Congress to create the Bank of United States in December 1790 and the enabling legislation was passed in February 1791. The Bank was capitalised at US$ 10 million of which US$2 million was owed by the US government, making it not only substantively larger than the next three biggest banks combined, but also possessing an implicit government guarantee. The Bank could establish branches in all American states, taking deposits and lending to the private sector, which would promote economic development. It should be no surprise that the initial public offering was vastly oversubscribed. Its federal charter expired after its twenty year initial year period, owing to political opposition to the Bank. Additional details can be found in Sylla, Leger, and Wright (1987) and James (2015).

2. Because some speculators attempted to corner the market in the stock of the Bank of the United States in an effort to gain controlling interest, prices for sovereign bonds and equity shares both soared and then collapsed when that cornering effort turned unsuccessful, triggering the 1792 financial panic that Hamilton astutely managed.

3. Between 1790 and 1860 state and local governments spent over $425 million on transportation investments, whereas the federal government spent only $54 million.

4. American states generated revenues from banks in two ways. One, investors had to pay to establish, or incorporate, a commercial bank and then special profit taxes applied to banks. Two, the state government offered investments in commercial banks incorporated within its borders to promote financial services and to generate states revenue from their profits earnings, which benefited considerably from monopolistic positions. However, state-chartered commercial banks had to compete with the Second Bank of the United States, which also regularly demanded specie payment for bank notes issued by state-chartered banks. When the federal charter for the Second Bank of the United States was allowed to lapse in 1836, it ushered in the era of Free Banking in the United States (see Rolnick and Weber 1982).
5. States also moved from special to general incorporation frameworks, which established uniform rights and governance structures for corporations, reducing the scope for state legislatures to grant special privileges that were seen as a source of corruption (Wallis). General incorporation for banks led to the period of ‘Free Banking’ – characterised by the rapid increase in the number of banks.

6. West Virginia, which was part of Virginia at the onset of the US Civil War (1861), is counted as in the South for this purpose. It was admitted to the Union in June 1863.

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References


