Who will pay the bill in Sicily?

by Augusto Hasman and Maurizio Iacopetta

Rumors of a Sicily's possible default are in the air again. The employees of the Sicilian parliament did not receive their checks at the end of September. Another possible default of Sicily made already the international headlines in July (see the New York Times 22/07/12) due to the contagion effects it could have had on other regions. But in that occasion, the central Italian government prevented Sicily's default by providing an immediate injection of liquidity in the order of 400 million euros.

Other Italian regions are in trouble. In recent months the provision of basic health care services has deteriorated; regions are renegotiating contracts with their creditors to obtain deadline extensions. The figures reported by Pierre de Gasquet in *Les Echos* of 02/10/2012, give a good idea of the deterioration of the Italian regional public finance over the last decade.

It will take a good deal of imagination for regional governments to come out of the impending budget crisis, not only in Italy but also in other European countries that have difficulties in managing their public debts, such as Spain, Ireland and Greece.

In recent weeks we learned that some local politicians are endowed with a good deal of creativeness, but they hardly use it to find a solution to the budget crises. The governor of the region Lazio –where Rome is located – resigned a few days ago in the midst of a political scandal due to revelations that members of the regional parliament funneled electoral

funds to pay extravagant personal expenses, including car upgrades and luxury vacations.

Why don't regional governments issue their own money to finance public expenditures? It may seem absurd that now that European countries have finally accepted a common currency, regional and possibly local governments might be tempted to create some sort of fiat money. But historically it would not be the first time that local monies emerge when the central government has its hands tight.

Argentina in the early 1990s (convertibility law n° 23.928, 27/03/1991) pegged the currency on a one-to-one basis with the U.S. dollar (See Anne-Laure Delatte's article on this blog for a parallel between the Argentinean events and hypothetical scenarios for Greece.). For most of the decade, things seemed to be working well; the economy was growing at the impressive annual rate of almost 5.7%, notwithstanding (or perhaps thanks to) the fact that Argentina, in practice, gave up the monetary policy instrument. But by 1998, the load of public debt started to become unbearable. Financing it by printing money was out of question. The IMF was called for help to prevent the panic of Argentinean savers. It granted a loan of 40 thousands million dollars but it also asked the government to impose a severe austerity plan, which had, among many effects, that of depriving provinces under financial difficulties from the prospect of being rescued by the central government.

It was at this point, in 2001, that a number of provinces began to print their own money in order to pay wages and current expenses. (Krugman's open editorial of ten years ago at the New York Times – Crying with Argentina, 01.01. 2002 – gives a fresh reading on the unfolding of the events). Fifteen out of twenty-two provinces ended up using newly issued interest-bearing notes, which earned the name of 'quasi-money'. At the beginning, thanks to an agreement between provinces and large stores, quasi-money had a high level of acceptability. Indeed, competition led more and more stores to

accept the quasi-money. Local trade seemed to resuscitate. In August 2002, 5 thousands million pesos of quasi-money circulated side-by-side with 12 thousands million of (real) Argentinean pesos.

Interesting, although the case of Argentina seems very surprising, the academic literature has always been puzzled of why it does not happen more often. The question is why government non-interest bearing banknotes circulate side-by-side with government bonds that promise an interest. In principle the phenomenon defies an elementary no-arbitrage principle.

One of the first to pose the puzzle was Hicks in 1935 in a famous article by the title of 'A suggestion for simplifying the theory of money'. An answer to Hicks' puzzle was offered by Bryant and Wallace (1980). Their argument is based on observation that private banks are not allowed to slice large denomination government bonds in small denomination banknotes. If banks could issue their own small denomination notes that are fully backed by large denomination government bonds, then, competition among banks would presumably drive the return on private banknotes in line with the return on bonds. If interest rates on bonds are positive, the argument goes, the demand for non-interest bearing money should then fall to zero. For Bryant and Wallace only the legal restriction on intermediation would prevent this from happening.

But Makinen and Woodward (1986) report that, during the period from 1915 to 1927, French government treasury bonds circulated at a relatively small denomination of 100 Francs (roughly 50-60 euros of today). The bonds were issued with terms of 1 month, 3 months, 6 months, and 1 year. These bonds were continuously available to all banks (including branches of the Bank of France), post o□ces, and numerous local o□ces of the Finance Ministry. This historical episode casts some doubts on the legal hypothesis, for the Bank of France kept issuing Francs.

Why then in Argentina bonds emerged as money – albeit for a limited period? It seems to us that the key was the promise offered by the issuer to accept the regional bonds in settling a debt – typically a tax obligation. The rules on what the regions can and cannot do in Europe are different from country to country. In Italy for instance regions, provinces, and municipalities have been authorized to issue bonds by the law of 'rationalization of public finance', introduced in the first half of the 1990s (art. 32 of the law of 8.6.1990 n.142, for municipalities and provinces, and art.35, law 23.12.1994 n. 724). The law set several conditions for an administration to qualify to issue bonds. First, bonds can be issued only to finance investment projects. The law explicitly forbids the issue of bonds to finance current expenditures. Second, the issuer has to demonstrate a good history of balanced budgets. Third, the maturity of the bonds cannot be shorter than five years. Fourth, the bonds cannot go in direct competition with the central government bonds, namely cannot be offered a real return above the one offered by the central government for bonds with similar maturities. Fifth, the central government is not allowed to back-up bonds of the regions who, in turn, cannot take responsibility for the bonds issued by provinces or municipalities

Is it desirable to relax these conditions? Perhaps it is useful to see the end of the story in Argentina –not particularly that of a Hollywood movie. The acceptability of quasi-money outside the region that issued it was very low. More importantly, the central government did not allow tax payers to use quasi-money for their federal taxes. Consequently, in a few months the de-facto exchange rate between the quasi-money and the national currency dropped from 1 to around 0.7 – it was somewhat higher for Buenos Aires quasi-money, for this was accepted in many other provinces.

At the beginning of 2002, a new government, presided by Eduardo Duhalde, decided to abandon the convertibility law.

As a result, the exchange rate of the pesos vis-à-vis the U.S. dollar dropped from one to four. During that year, the GDP declined 10.9%.

Having gained the power of printing money again, the central government allowed quasi-monies holders to convert them into the devalued national peso. The short run benefits evaporated soon. The recession along with the depreciation slashed the purchasing power of the working class. At the end of the crisis, the national product was about a quarter lower than its 1998 level, and the rate of unemployment shot up to 24%. It appears that issuing of local money delayed the collapse of the financial system, but it is unclear whether the temporary breath gained by local administrators that issued bonds made the subsequent recession less severe. The case of Argentina suggests, nevertheless, that a major relaxation of the current constraints of regional and municipal entities is not going to help solve how to guarantee the provision of health care service in the long run. Nonetheless, the current policy of cutting basic public services indiscriminately is the least imaginative of the solutions. Alesina and Giavazzi in an open editorial published on Corriere della Sera on Sept 27, suggested that hospitals could charge health care users directly instead of being reimbursed by the regional authorities. By doing so, they argued, not only the quality of the service would improve, but regions would need fewer resources. Although this is food for thought, in the U.S. such a system generated a colossal profit making machine that contributed to the explosion of the health care costs. Similarly, Fitoussi and Saraceno (2008) argue that the spectacular gain in income of the last three decades in China did not go hand-in-hand with similar gains in life expectancy and quality of health care, because the government opted for a health care system based on out-of-pocket expenses.

The Argentinean experience tells us that local administrators in distressed regions of Europe are going to lobby the

government to give more freedom in managing their budget intertemporally – something that is already happening in Spain, and is summarized in the London School of Economics blog by K. Basta . They are also probably going to make more intensive use of 'creative accounting', so as to prolong their serving time in office. But this will not be the solution. A major reassessment of the national government's priorities in combination with a sensible monetary policy at the European level is the only way out. We badly need to free up resources to revitalize the public educational system and to maintain the overall good standard of public health care services.

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France-Germany: The big demographic gap

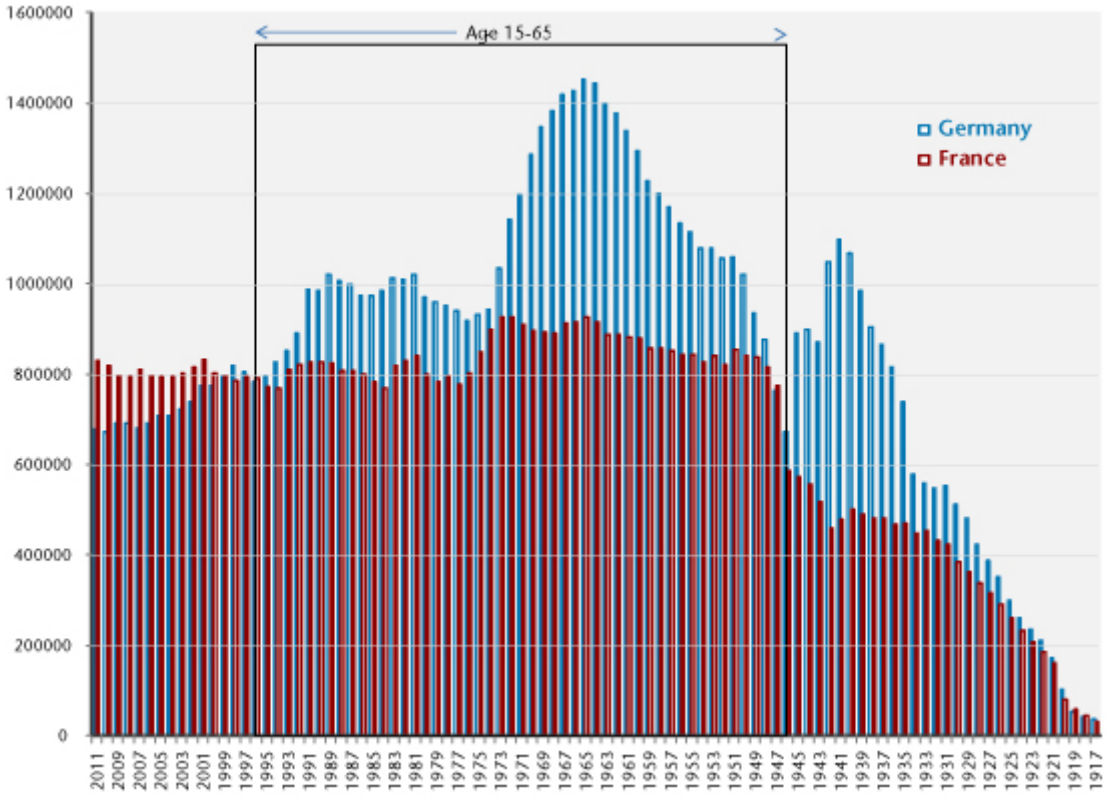
By Gérard Cornilleau

The divergence in the demographic trajectories of Germany and France will have a major impact on social spending, labour markets, productive capacity and the sustainability of public debt in the two countries. The implications are crucial in particular for understanding Germany's concern about its debt. These demographic differences will require the implementation of heterogeneous policies in the two countries, meaning that

the days of a “one-size-fits-all” approach are over.

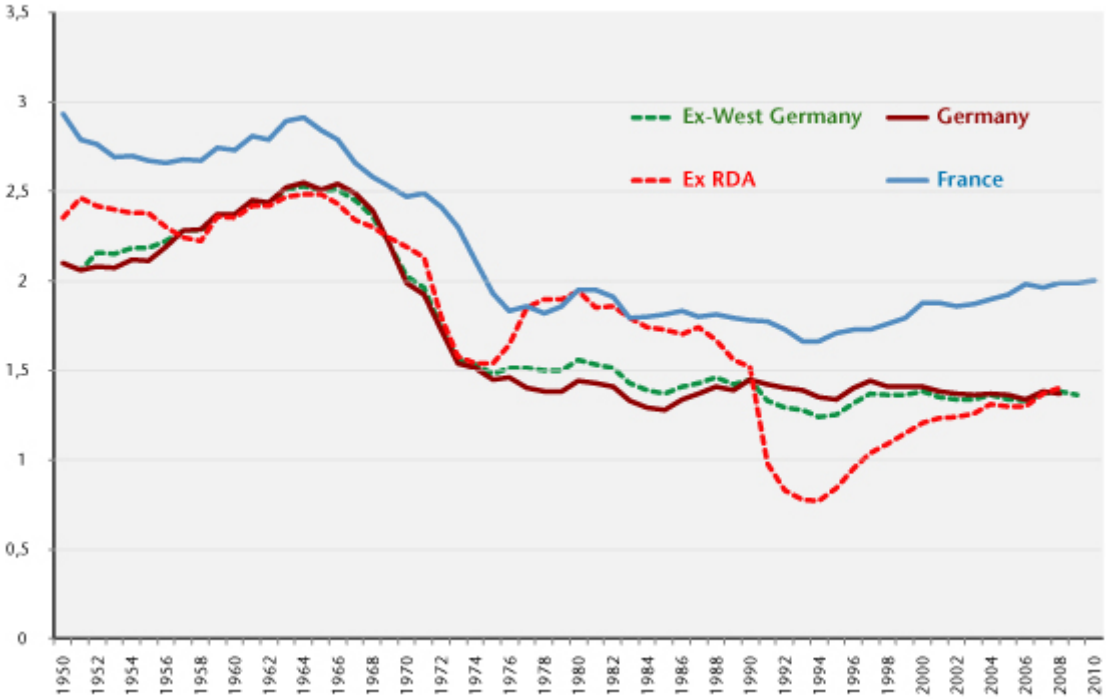
The demographic trajectories of France and Germany are the product of Europe’s history, and in particular its wars. The superposition of the age pyramids (Figure 1) is instructive in this regard: in Germany the most numerous generations are those born during the Nazi period, up to 1946; then come the cohorts born in the mid-1960s (the children of the generations born under the Nazis). In contrast, in France the 1930s generation is not very numerous. As a consequence, the baby-boomer generation which, as can be easily understood, kicked off earlier than in Germany (starting in 1945, at a time of a baby crash in Germany that ended only in the early 1950s, with the German baby boom peaking somewhat late, in the 1960s), was limited in scale, as people of childbearing age were not numerous. On the other hand, the birth rate in France slowed much less in the wake of the 1970s crisis, and most of all it has risen again since the early 1990s. This has resulted in the fertility rate remaining close to 2 children per woman of childbearing age, so that the size of the generations from 1947 to the present has remained virtually constant. German reunification led to a collapse in the birth rate in former East Germany, which converged with the rate in ex-West Germany in the mid-2000s (Figure 2). Overall, French fertility has generally been higher than German fertility in the post-war period, with the gap widening since the early 2000s. As a result, the number of births in France is now substantially higher than the number in Germany: in 2011, 828,000 compared with 678,000, *i.e.* 22% more births in France.

Figure 1. Age pyramids in 2011



Source: Eurostat.

Figure 2. Instantaneous fertility indicators in France and in Germany



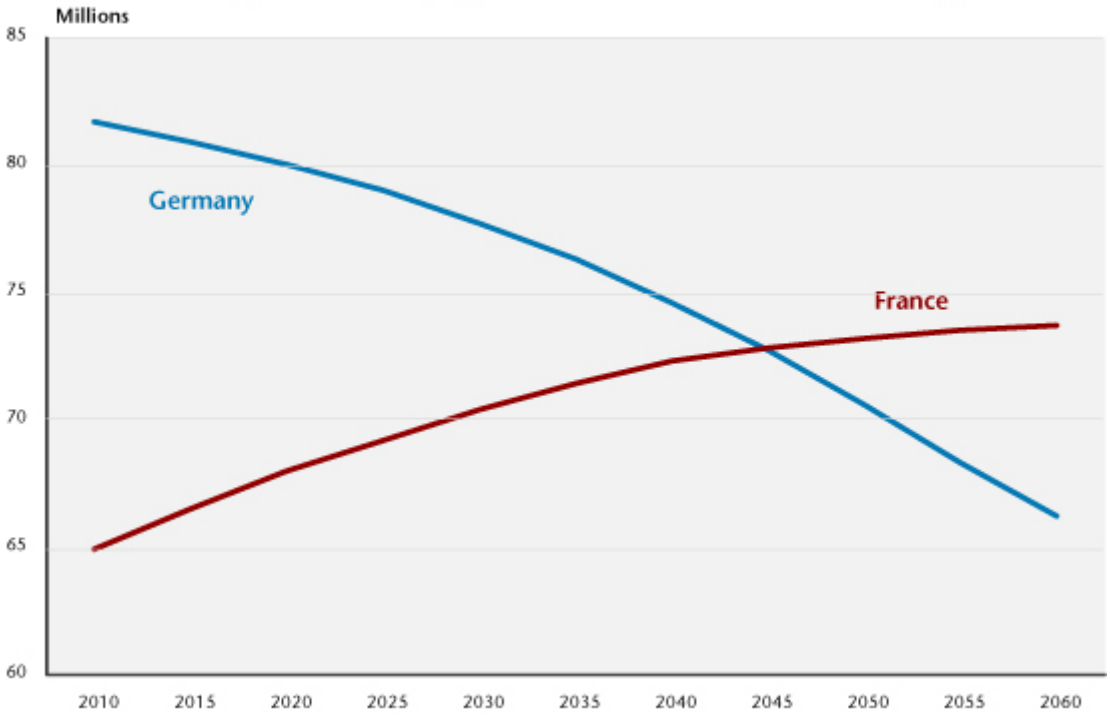
Source: INED.

From a demographic standpoint, France and Germany are thus in radically different situations. While France has maintained a satisfactory fertility rate, almost sufficient to ensure the long-term stability of the population, Germany's low birth rate will lead to a substantial and rapid decline in the total population and to much more pronounced ageing than in France (Figures 3 and 4).

According to the population projections adopted by the European Commission [1], Germany should lose more than 15 million inhabitants by 2060, while France gains just under 9 million. By 2045, the populations of the two countries should be the same (a little under 73 million), while in 2060 France will have approximately 7 million more people than Germany (73 million against 66 million).

Migration is contributing to population growth in both countries, but only moderately. Net migration has been lower in Germany during the most recent period, with a rate of 1.87‰ between 2000 and 2005 and 1.34‰ between 2005 and 2010 against, respectively, 2.55‰ and 1.62‰ in France [2]. The net migration rates adopted by the European Commission for France and Germany are similar, with a contribution to population increase by 2060 on the order of 6% in each country [3]. The UN [4] uses a similar hypothesis, with the contribution of migration growing steadily weaker in all countries. This reflects a general slowdown in overall international migration due to rising incomes in the originating countries. In this situation, Germany does not seem to have a large pool of external labour available, as it has limited historical links with the main regions of emigration.

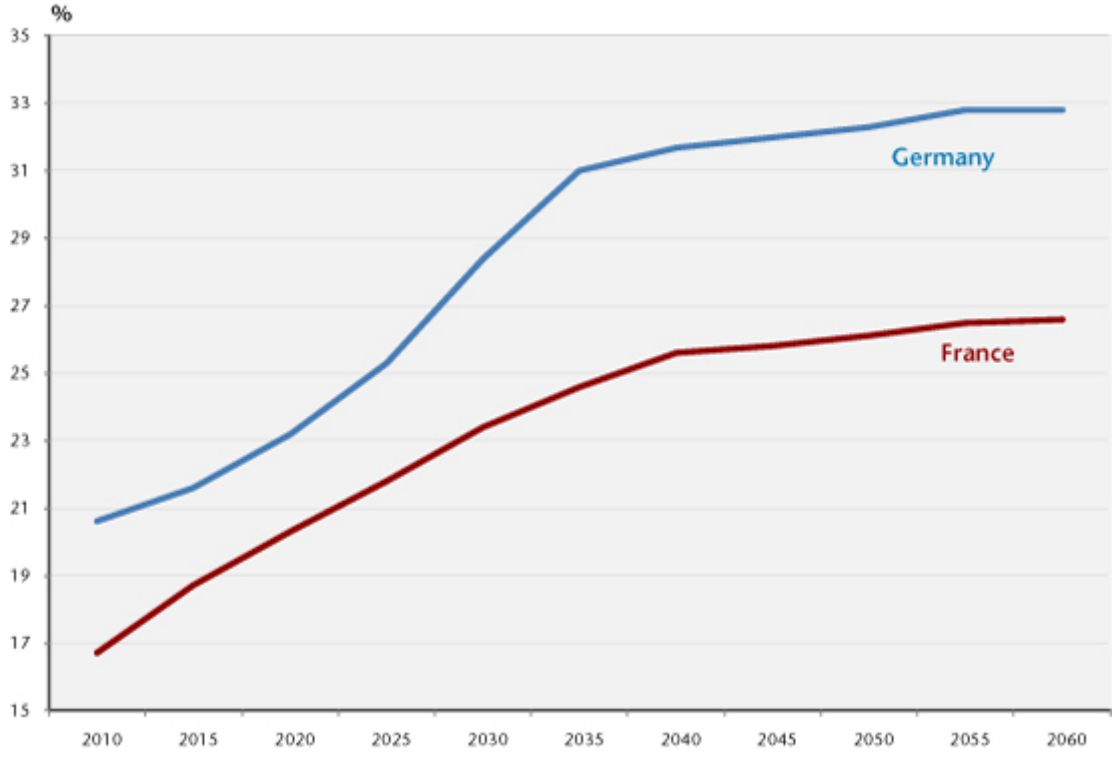
Figure 3. Total populations in France and in Germany



Source: European Commission, "The 2012 Ageing Report".

This inversion in demographic weight thus seems inevitable, and it will be accompanied by a divergence in the average age of the population, with considerably more graying of the population in Germany than in France (Figure 4). By 2060, the share in the total population of those aged 65 or older will reach almost one-third in Germany, against a little less than 27% in France.

Figure 4. Share aged 65 and over in the total population



Source: European Commission, "The 2012 Ageing Report".

As a consequence, and in light of the reforms implemented in the two countries, the share of GDP that goes to public spending on pensions would increase a little in France and a lot in Germany. According to the Report of the European Commission (*op. cit.*), between 2010 and 2060 this share would rise in France from 14.6% to 15.1% of GDP, up 0.5 GDP point, but by 2.6 points in Germany, from 10.8% to 13.4%. This is despite the fact that the German reform of the pension system provides for postponing the retirement age to 67, while the French reform postpones it only to 62.

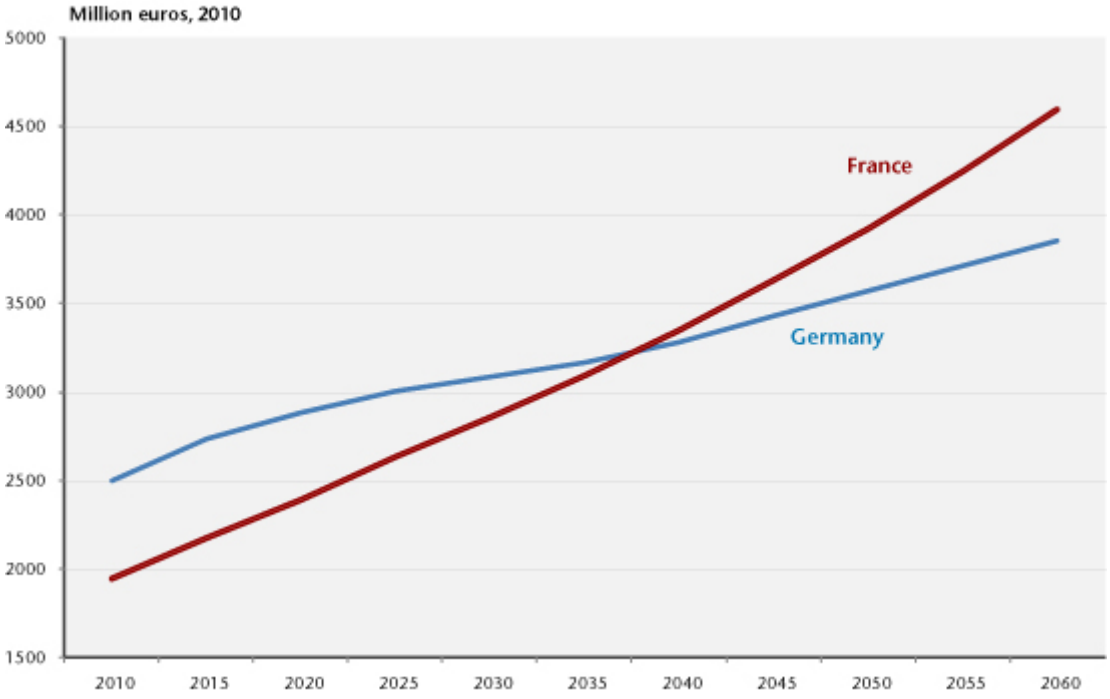
Demography also has an impact on the labour market, which will be subject to changing constraints. Between 2000 and 2011, the French and German workforces increased by the same order of magnitude – +7.1% in Germany and +10.2% in France – but while in Germany two-thirds of this increase resulted from higher labour force participation rates, in France 85% of the increase was due to demography. In the near future, Germany will come up against the difficulties of further increasing its rate. Germany's family policy now includes provisions,

such as parental leave, which aim to encourage female employment through a better reconciliation of work and family life, but female participation rates are already high, so that the problem now is more that of increasing the fertility rate than the labour supply. France, which is starting from a lower participation rate, especially because older workers leave the labour market much earlier than in Germany, has greater reserves to draw on. In recent years, the disappearance of early retirement and the increase in the working years required to receive a full pension have begun to have an impact, with the employment rate of older workers rising significantly, even during the crisis [5]. The employment of older workers has also increased in Germany, but it is not possible to continue to make significant increases in this area indefinitely. The most likely result is a long-term convergence in employment rates between France and Germany. Ultimately, then, according to the projections of the European Commission [6], the German participation rate is likely to increase by 1.7 points between 2010 and 2020 (from 76.7% to 78.4%), while the French rate increases by 2.7 points (from 70.4% to 73.1%). By the year 2060, the French participation rate will increase more than twice as much as the German rate (4.2 points against 2.2). But France's rate would still be lower than Germany's (74.7% against 78.9%), meaning that France would still have reserves to draw on.

This divergence in demographics between the two countries has major consequences in terms of long-term average potential growth. Again according to the projections of the European Commission (which are based on the assumption of a convergence in labour productivity in Europe around an annual growth rate of 1.5%), in the long term potential growth in France will be double the level in Germany: 1.7% per year by 2060, against 0.8%. The difference will remain small until 2015 (1.4% in France and 1.1% in Germany), but will then grow quickly: 1.9% in France in 2020, against 1% in Germany.

Just as for the population figures, this will result in a reversal of the ranking of French and German GDPs by about 2040 (Figure 5).

Figure 5. GDP in France and in Germany



Source: European Commission.

The demographic situations of France and Germany thus logically explain why there is more concern in Germany than in France for the outlook on age-related social spending. This should lead to a more nuanced analysis of the countries' public debts: given the same ratios of debt to GDP in 2012, over the long term France's public debt is more sustainable than Germany's.

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[1] Cf. "The 2012 ageing report", *European Economy* 2/1012.

[2] Cf. United Nations, Department of Economic and Social Affairs, Population Division (2011). *World Population Prospects: The 2010 Revision*, CD-ROM Edition.

[3] Net migration is projected to be slightly higher in Germany than in France, at a level of 130,000 per year in 2025-2030, but under 100,000 in France. But the overall

difference is very small: in 2060, cumulative net migration between 2010 and 2060 would increase the population by 6.2% in Germany and by 6% in France (as a percentage of the population in 2010).

[4] *Op. cit.*

[5] See the summary of changes in the labour force in 2011 by the Insee: http://www.insee.fr/fr/ffc/ipweb/ip1415/ip1415.pdf .

[6] *Op. cit*.