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Government–Financial Market Relations after EMU

New Currency, New Constraints?

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ABSTRACT

The European Monetary Union (EMU) has generated a variety of changes, including the loss of national monetary policy autonomy and the creation of deeper integrated intra-European markets for goods, services, and financial instruments. This article explores the extent to which EMU has changed the ways in which and the extent to which international financial markets influence national policy choices. There are important reasons to expect that financial markets will exert greater influence on governments after EMU; for instance, governments now borrow in what is essentially a foreign currency. This change might serve to heighten the perceived danger of default in Europe. At the same time, however, financial markets appear to reward governments for the fiscal consolidation and increased market liquidity that flow from the single currency. I argue that, as a result of these offsetting trends, there have thus far been no dramatic changes in financial market–government relations. Although governments continue to face external pressures on domestic policy-making, these pressures may be only slightly more severe for EMU than for non-EMU countries. As in the past, domestic politics and institutions will be as important as, if not more important than, financial market pressures in EU governments' policy decisions.

KEY WORDS

- EMU
- financial globalization
- government bond market
- international capital markets
- Stability and Growth Pact
- Sweden

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Introduction

The advent of Economic and Monetary Union (EMU) in Europe has brought a variety of changes, including the loss of national monetary policy autonomy and the creation of deeper intra-European markets for goods, services, and financial instruments. EMU also brings greater attention to national fiscal policies, as some governments struggle to comply with the Stability and Growth Pact (SGP) and others call for its enforcement. These calls are, in part, based on the assertion that financial markets will react unfavorably to continued fiscal deficits, placing even greater pressures on governments.

This argument begs the question of the strength of financial market influences. How important have private capital markets been to past government policy choices? To what extent has EMU changed the ways in which and the extent to which international financial markets influence national policy choices? How are government–financial market relations in EMU nations different from those in non-EMU nations, and how might these differences affect future accessions to EMU?

There are important reasons to expect that financial markets will exert greater influence on governments after EMU. For instance, EMU governments now borrow in what is essentially a foreign currency, and this might serve to heighten the perceived danger of default. But, at the same time, financial markets reward governments for the fiscal consolidation and increased market liquidity that flow from the single currency. Owing to these offsetting patterns, then, there have been no dramatic changes in financial market–government relations. Although governments continue to face external pressures on domestic policy-making, these pressures are only slightly more severe for EMU than for non-EMU countries. As in the past, domestic politics and institutions are more important than financial market pressures in European Union (EU) governments' policy decisions.

This article first reviews the extant literature on financial market–government relations. It then discusses several ways in which EMU may change the pattern of financial market–government relations, including the added risk of default on government debt and the unenforceability of the SGP. Finally, the article examines the extent to which policy-making in one non-EMU member, Sweden, has been influenced by global capital markets, and suggests how these influences could change with EMU membership.

Financial globalization and European welfare states

During the past decade, scholars have devoted substantial attention to the impact of economic globalization on national policy choices. This literature

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falls into two broad groups: convergence and divergence (see Garrett, 1998, 2000; Garrett and Mitchell, 2001; Mosley, 2003). Predictions of cross-national (and downward) convergence hinge on competition and efficiency. As races to the bottom ensue, governments lose the ability to provide goods and services for their citizens. Predictions of divergence, meanwhile, are based upon continued diversity across national institutions and domestic interests (Huber and Stephens, 2001; Pierson, 2001).

In the realm of capital markets, investors' capacity for exit is central to convergence accounts. Given financial openness, governments must sell their policies not only to voters but also to international investors, who can respond dramatically to actual or expected policy outcomes (Obstfeld, 1998; Simmons, 1999). The alternative (divergence) perspective maintains that firms and individuals have different preferences over taxation, services, and regulation; they will locate in the jurisdiction that best matches their preferences (Hall and Soskice, 2001; Huber and Stephens, 2001; Kitschelt et al., 1999; Rogowski, 2003).[1] Moreover, as economic openness increases, democratic governments have political incentives to insulate individuals from externally generated insecurity, even if such compensation entails costs (Adserá and Boix, 2002; Garrett, 1998; Rodrik, 1997).

Recent empirical work assessing the convergence and divergence hypotheses reveals a mixed pattern, particularly in the advanced capitalist democracies. Substantial cross-national diversity remains in public consumption spending, government transfer payments, public employment, and taxation, whereas aggregate fiscal and monetary policies have increasingly converged (Garrett and Mitchell, 2001; Huber and Stephens, 2001; Scruggs and Lange, 2002; Swank, 2002). The latter often is associated with economic internationalization, while the former reveals the continued influence of domestic politics and institutions (Clark and Hallerberg, 2000; Oatley, 1999).

This literature, however, does little to explore the causal mechanisms underpinning government policy outcomes. For instance, how do financial market participants evaluate government policy, and how do these evaluations contribute to policy choices? In previous work, I examine the government bond market, which is a most likely locus of financial market influence. I suggest that capital market openness allows investors to react swiftly and severely to changes in government policy outcomes. More importantly, I find that investors' consideration of government policies varies markedly across groups of countries. This pattern is driven by variation in investors' concerns about government default, as well as the relative costs and benefits of employing information (Mosley, 2003).

In the developed world, capital market participants consider only a narrow set of government policies, i.e. key macroeconomic indicators, but not supply-side policies. The result is a 'strong but narrow' financial market

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constraint. Investors assume that OECD governments will repay their debts, leaving these governments with measurable policy autonomy. Governments of developed countries that conform to capital market pressures in certain macro-policy areas, particularly overall inflation and government budget balances, are relatively unconstrained in supply-side policies. Therefore, despite financial internationalization, we continue to observe cross-national policy divergence among advanced democracies. For developing nations, however, the scope of financial market influence includes both macro- and micro-policy areas. Market participants, concerned with default risk, assess many dimensions of government policy. These nations are more likely to exhibit cross-national convergence, as financial market pressures are both strong and broad.

Several types of evidence support this argument, including interviews with and surveys of professional investors, and cross-sectional time series analyses. Investors are concerned with developed country governments 'getting the big numbers right,' but much less so with governments' partisan affiliations or micro-level policies. The means by which governments achieve macro-policy outcomes, and the nature of government policies in other areas, do not concern investors. Therefore, governments are left with 'room to move.' This conclusion not only provides theoretical support for previous empirical findings, but also is consistent with the notion that 'stresses on contemporary welfare states would be there with or without globalization' (Pierson, 2001: 82; Iversen and Cusack, 2000). Moreover, the 'room to move' argument suggests that the sources of variation across EU government policies are more likely internal than external.

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EMU and global capital markets

The evidence underpinning the 'room to move' argument was collected prior to the 1999 launch of EMU. How has the advent of the single currency affected government–financial market relations? In this section, I discuss the general consequences of EMU for economic policies, as well as the impact of EMU on financial market–government relations. Do investors penalize governments for failing to implement fiscal restraint fully? Do financial markets, via their responses to EMU, alter incentives for non-EMU members to join?

Consequences for fiscal policy

Given the criteria for participation in EMU, as well as the mandate of the European Central Bank (ECB), EMU should promote lower inflation and

sounder public finances. It also should facilitate cross-border flows of goods, capital, and services. The single currency renders taxes and other distortions more transparent, reduces currency risk and the need for hedging, and creates larger economies of scale (Danthine et al., 2001; Galati and Tsatsaronis, 2001; Gros and Lannoo, 2000).

At the same time, EMU removes governments' control over monetary policy, and the Stability and Growth Pact (SGP) requires national budgets to approach medium-term balance or surplus. Although governments might welcome added pressure for discipline, they also might find themselves facing asymmetric economic shocks and domestic pressures for welfare state maintenance. Asymmetric shocks might be severe, particularly if the euro area does not become an optimum currency area (Crowley, 2001). EMU could become a difficult issue within domestic politics, especially as the euro creates winners and losers (Frieden and Jones, 1998).

Many of the consequences of EMU appeared prior to 1999, as governments attempted to meet the Maastricht convergence criteria and as economic actors anticipated the impact of EMU. For instance, investors adopted the Maastricht guidelines on government deficits (not to exceed 3% of GDP) as a key decision-making criterion. Prior to the mid-1990s, market participants took a 'less is better' view of budget deficits. They did not expect governments to meet a specific deficit target, or to do so by a particular date. The Maastricht recommendations served to specify fiscal limits and to provide a common language for investors (Mosley, 2003). In early 1997, for instance, investors analyzed Italy's fiscal actions very closely, asking 'will this get them below 3% or not'?

A central reason for market participants' use of the Maastricht rules was governments' use of the criteria. Bond market participants attempted to predict who would join the first round of EMU in 1999, and the criterion mattered for that decision. Investors also interpreted adherence to the Maastricht criteria as a signal of resolve: if a government were strongly committed to EMU, it would find a way to meet the deficit target. The deficit criterion, however, also gained independent status. Market participants routinely evaluated non-EU states according to the Maastricht limit (Mosley, 2003). Nations such as Sweden and Norway also faced some financial market pressures to reduce their deficits, even though they did not aspire to adopt the euro (Huber and Stephens, 2001).

Although market participants used the Maastricht criteria extensively, they also viewed them as flawed. Market actors saw 'no good, objective reason' to use 3% or 'to make no allowance for cyclical variations in the deficit.' One market participant pointed out that 'it is the convergence of macroeconomic factors, not the level at which they converge, that is

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important' (interviews with fund managers, 1997 and 1998). Despite these objections, investors' widespread use of the deficit criterion strengthened the financial market constraint. At the same time, when it became evident that EU governments would not strictly interpret the Maastricht public debt criterion, market participants began to ignore it. As with pre-Maastricht deficits, market participants preferred less debt to more debt, but they did not rely on the 60% reference value. Meanwhile, investors clung to the deficit threshold, embracing German finance minister Theo Waigel's insistence that '3% means 3%.'

EMU and the government bond market

EMU should accelerate financial market integration in Europe. Because investors no longer face intra-European currency risk, the markets for sovereign and corporate debt, as well as for equities, should deepen (De Bondt, 2002; Gros and Lannoo, 2000; OECD 1999, 2002a). Although these effects have yet to obtain fully, owing to differences in regulatory frameworks, European asset markets are becoming more integrated (Antzoulatos and Klinaki, 2002; Mann and Meade, 2002). On the sovereign side, the euro-denominated debt market now is almost equal in size to the US Treasury bond market (Galati and Tsatsaronis, 2001; OECD, 2002a).

Stage 3 of EMU could have several effects central to government–financial market relations. Prior to the single currency, investors in Europe worried little about default risk; rather, inflation (and therefore currency) risk was the main determinant of spreads among sovereign borrowers. The economic fundamentals important to investors were exchange rates, inflation rates, government budget deficits, and current account balances, as well as expectations regarding EMU. In January 1999, cross-national differences in inflation and currency risks disappeared. Both German and Italian government bonds are now denominated in euros and affected by the same monetary policy. Two EMU-induced changes are potentially important: the decline of resident investment and the emergence of default risk.

Resident investment and debt management

Generally, institutional investors from continental Europe have made large investments in domestic government securities (Gros and Lannoo, 2000). In the 1990s, governments with high levels of indebtedness, such as Belgium and Italy, were quick to point out that most of their debt was owned by their residents, rendering them less susceptible to financial market pressures. Additionally, several studies have noted a home-country bias in investment: investors do not diversify internationally to the extent that portfolio

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management theory suggests (Ahearne et al., 2001; Obstfeld, 1998). Rather, they invest in their own markets at higher-than-optimal levels. And, in their study of the 1994 European bond market, Borio and McCauley (1996) find that higher levels of market volatility are strongly correlated with lower proportions of resident investors. Therefore, resident investment might provide governments with a cushion against financial market pressures.

Three causal mechanisms underlie the resident/non-resident distinction. The first is regulation: if governments regulate resident investors differently from non-resident investors, the two groups will behave differently. The second is information: resident investors may have better-quality or lower-cost information. Moreover, because non-residents have a small percentage of their holdings in any given market, their incentives to gather additional information about a particular country are modest (Kaufmann et al., 1999; Mosley, 2003). Third, resident investors are often individual – 'Belgian dentists and Italian grandmothers' – rather than institutional (professional) investors. For instance, household investors traditionally held most Italian government securities; institutional investors played a relatively marginal role, holding only 11% of bonds in the early 1990s, compared with approximately 45% of outstanding bonds in the UK and France (Conti and Hamaui, 1994). Individual investors may act differently not because of nationality but because of different asset allocation processes.

Each mechanism implies that nations with greater levels of resident investment are more insulated from financial market pressures. And there is a relationship between reliance on resident investment and fiscal laxity: for 1995–2001, a positive correlation (Pearson's $r = .58$) exists between the government budget balance and the portion of debt held by non-residents. EU nations with higher resident investment tend to have larger budget deficits as well as greater public debt.[2] Of course, the resident investment strategy could have costs, leaving governments to rely on a smaller pool of capital.

How might levels of resident investment – and its benefits to governments – change with EMU? First, the euro has rendered currency-matching regulations obsolete. EU-licensed insurance companies, for instance, are required to hold 80% of assets in the same currency as their liabilities. At the end of 1998, these companies invested over half of their assets in home-country government and government-guaranteed securities (Vota, 1999; Danthine et al., 2001). After EMU, however, the euro is the local currency, so any euro-denominated asset qualifies (OECD, 1999, 2002a). For pension funds, EMU marks less of a change: British and Dutch funds account for the bulk of European pension fund assets, and neither country had meaningful restrictions on the currency denomination of investment (Gros and Lannoo,

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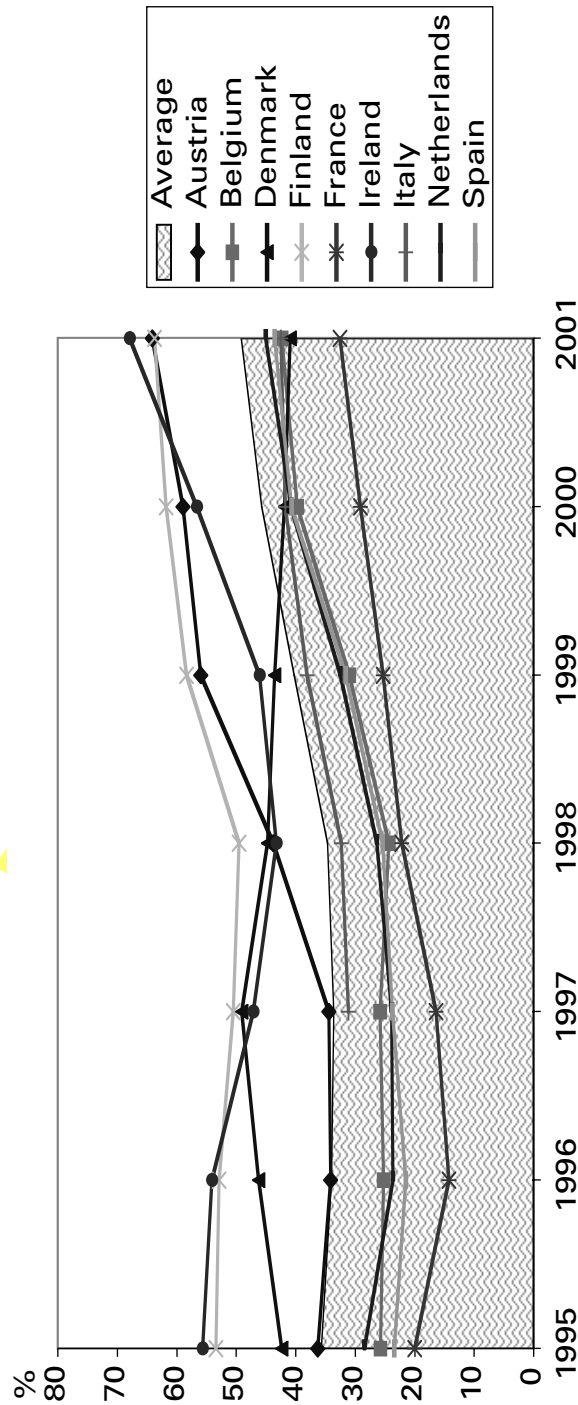

Figure 1 Percentage of central government debt held by non-residents.

2000). And some regulatory barriers persist: for instance, EU members thus far have failed to agree on a common withholding tax framework for bond investors.

Another impact of EMU involves currency risk: if the home-country bias in investment results from an aversion to currency risk, this bias should disappear. Governments will find themselves competing to attract investment. This effect should be stronger in nations with traditionally high levels of resident investment, such as France, Belgium, and Finland. Changes in patterns of resident investment have begun to appear: for instance, Galati and Tsatsaronis (2001) report that, in 2000, non-resident holdings of Belgian securities reached 53%, up from 29% in 1997; and non-resident holdings of debt doubled, to 33%, in France. Over the longer term, non-resident holdings of German debt securities increased from 15% in 1990 to more than 40% in 2000 (OECD, 2002a). Figure 1 displays general trends in non-resident debt holdings for the period from 1995 to 2001, for the nine EU nations for which data are available. Average levels of non-resident investment increased during the period, from 36% to 49%. These increases are more pronounced after EMU. In 2001, Austria, Finland, and Ireland appear most exposed to pressures from non-resident investors.

Therefore, some governments may have lost part of their 'captive audience' (Antzoulatos and Klinaki, 2002; *New York Times*, 14 November 1998). Institutional investors will rebalance their portfolios away from domestic assets, although this rebalancing may occur slowly. A rebalancing may serve to heighten the constraints on national governments. At the very least, governments will have to make greater efforts to make their bonds attractive to European investors. For instance, since 1998, the Irish debt management agency has embarked (with some success, as Figure 1 demonstrates) on an effort to market Irish debt to non-Irish investors. This effort was motivated by the concern that, without exchange rate considerations, there would be little motivation for Irish investors to buy Irish debt (*Financial Times*, 14 October 1998). Governments' marketing efforts may include routine debt management practices (Piga, 2002), such as increasingly liquidity for certain classes of bonds, but they eventually could include more pronounced measures such as changing tax rates or fiscal policy-making institutions.

Additionally, EU nations with smaller government bond markets may have difficulty exploiting the removal of currency risk. They continue to have the problem of low liquidity in their issues, especially compared with France, Germany, and Italy.[3] Recent data from the ECB indicate that these nations together account for over 72% of outstanding general government debt; Finland, Greece, and Portugal combined, however, account for just over 4%.[4] Nations with large and liquid government bond markets, such as Germany,

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may continue to access markets at relatively low rates, even while running larger fiscal deficits, whereas smaller nations, such as Austria, cannot.

Similarly, as the euro area becomes a more unified market, the benefits provided by investing in multiple euro zone countries decline. Therefore, as a means of balancing risks, professional investors might be inclined to seek investment opportunities outside of Europe.[5] A first-cut glance at broad patterns, however, suggests that this has not yet happened. On the eve of EMU, respondents to *The Economist*'s Quarterly Portfolio Poll (*The Economist*, 24 April 1999) allocated 28% of their bond holdings to euro zone nations. In the first quarter of 2000, this number stood at 27%; it increased to 32% in 2001, and stood at 31% in 2002.

Patterns of resident investment are one element in the broader realm of public debt management. European governments have long made choices about how to borrow – at what maturities, in what currencies, via which instruments? Borrowing in foreign currencies has allowed nations with higher credit risks (e.g. Sweden in the early 1990s) to access foreign capital at lower interest rates, in exchange for assuming currency risk. EMU, however, alters the nature and the importance of governments' debt management choices. Fiscal consolidation allowed many European governments to reduce their reliance on foreign currency debt. Stage 3 of EMU also transforms the nature of domestic currency debt: euro-denominated debt is both 'foreign' and 'domestic' (Piga, 2002).

With fewer choices regarding the currency denomination of debts, governments can focus on the maturity structure of debt. Governments face a trade-off here as well between borrowing at short maturities with lower interest rates and borrowing at long maturities with higher interest rates. The difference between short- and long-term interest rates reflects concerns about future patterns of inflation, which means that the differential is greater in countries with less monetary policy credibility. A government that concentrates on minimizing borrowing costs will focus on shorter-term borrowing; a government that is concerned with minimizing re-financing risk will employ longer-term borrowing. On the eve of EMU, there was substantial variation across countries in terms of the average maturity of public debt, ranging from 3.7 years in Italy to 7.0 years in Germany.[6]

Given the mandate of the ECB, EMU should improve governments' anti-inflation credibility, allowing governments to borrow at longer maturities with lower costs.[7] Although maturities continue to differ among EMU members, the variance has declined (Missale, 2001). For instance, Greece's average debt maturity increased from 1.63 years in 1994 to 6.05 years in 1999 (Deutsche Bank Research, *EMU Watch* 85, 2 June 2000). This was due to reduced inflation and better fiscal management; the pending entry into EMU helped convince investors that Greece's low-inflation commitment was

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binding. Membership, however, does not appear essential for achieving long debt maturities: at the start of EMU, the UK's average time to maturity was 10.2 years and Denmark's was 9.8 years.

The salience of default risk

When investors purchase sovereign debt, they assess the risk of non-repayment. These estimates of the ability and willingness to repay generate an interest rate premium. As a reflection of lower default risk, European governments traditionally have paid lower rates to borrow than have governments of developing nations, but rates among European borrowers have varied. Since EMU, interest rates among European borrowers have converged further, reflecting declines in inflation and liquidity risk. At the same time, however, European governments now borrow in a 'foreign currency.' The fact that governments can no longer monetize their debts – that is, they cannot print their own money as a means of repayment – could heighten default risk, generating interest rate penalties (Antzoulatos and Klinaki, 2002; Codogno et al., 2003; Favero et al., 2000; Missale, 2001).

To some extent, this is an empirical question: are the interest rate penalties for increased default risk larger or smaller than the rewards for reduced inflation and liquidity risk? This also is a theoretical question: the 'room to move' argument is based on the non-salience of default risk in developed democracies. Investors trust that governments will repay their debts and, as a result, they worry little about politics or about how governments allocate spending across various programmatic activities. Were default risk to become salient, investors would consider a wider array of government policies and therefore impose more of a constraint on contemporary welfare states.

In the mid-1990s, analysts offered widely varying predictions as to the pricing of default risk after 1998. Graham Bishop (1992), a fund manager at Salomon Brothers, predicted that increases in default risk after EMU would outweigh the elimination of currency risk. In the past, Europe was 'an automatic safe haven for investors' savings' (1992: 211); a single currency, however, would force investors to 'grapple with the question of the relative credit risk of the European Community governments' (1992: 207). Bishop suggested that market participants would differentiate among borrowers, rendering substantial interest rate convergence unlikely. Likewise, Buiter et al. (1993) predicted that market discipline would be strong, entailing significant risk premia for borrowers that continued to issue debt (also see *The Economist*, 11 April 1998; McKinnon, 1997).

On the basis of a formal model of default risk and fiscal policy, Restoy (1996) predicted a different outcome: inflation risk would disappear and the corresponding increase in default risk would be relatively small. Market-based mechanisms for fiscal discipline would be fairly powerful for moderately

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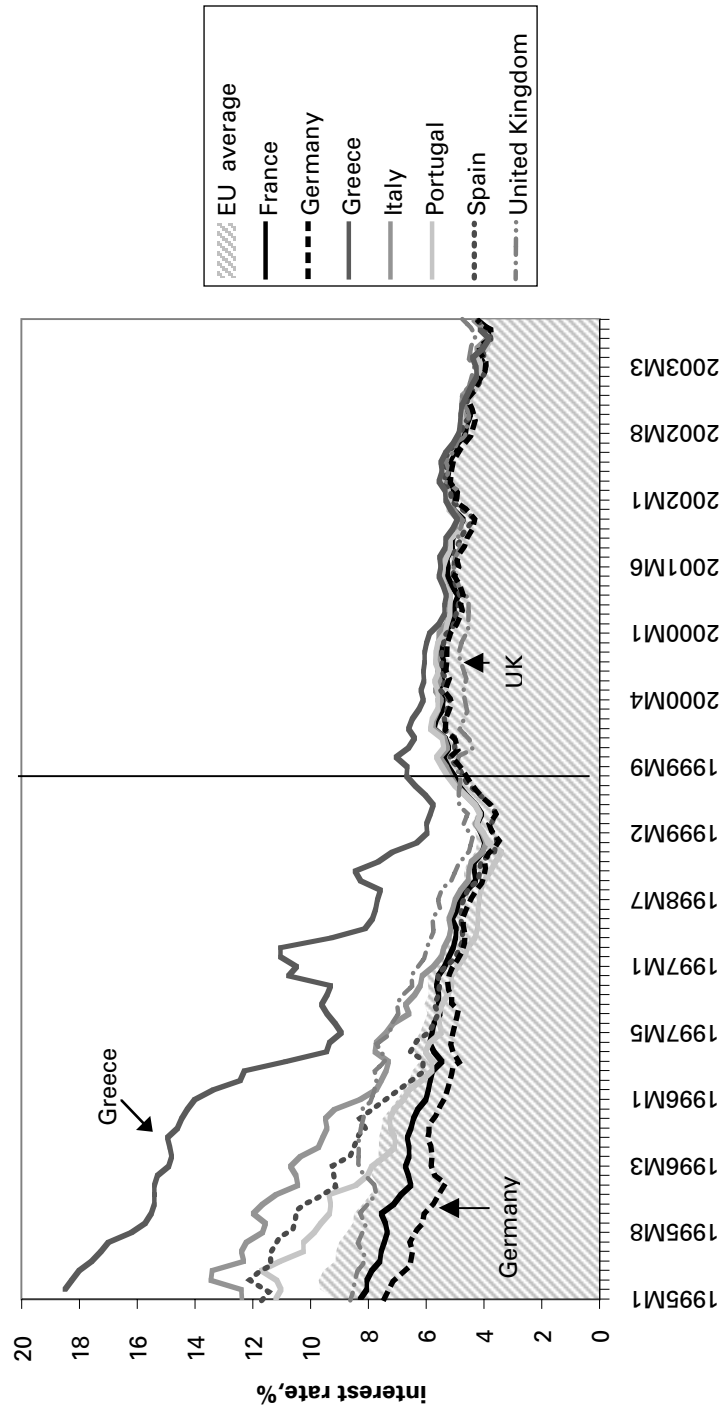

Figure 2 Interest rates on long-term government bonds.

indebted countries, but less so for highly indebted countries. For moderately indebted nations, then, increases in debt after EMU would produce substantial increases in interest rate premia. For highly indebted nations, however, credit would be more easily available; this reduction would stem from the inability of governments to monetize their debt. Therefore, a nation such as Italy or Belgium would have easier access to credit after EMU. Similarly, the International Monetary Fund (IMF, 1997) suggested that interest rate premia were an inadequate mechanism with which to influence government policy choices.

In late 1998, market participants suggested that default risk would rise after EMU, but not enough to generate substantial changes in interest rates. Investors' view was that, after EMU, there would be little differentiation among nations, small interest rate differentials, and, therefore, less attention paid to European fixed-income markets (Mosley, 2003). With budget deficits of 4–5% of GDP, investors would remain willing to lend to governments. Even with excessive deficits, a substantially increased probability of default would not manifest itself for several years (Holzmann et al., 1996); and governments retained the ability to counter high levels of debt with increases in taxation (Eichengreen and Von Hagen, 1996; Swank, 2002).

To what extent has default risk prevented a lowering of interest rates, and a loosening of financial market pressures on governments, after EMU? Figure 2 displays the interest rates on long-term government bonds for EU nations; the vertical line indicates the start of EMU. It is evident that spreads on government bonds have narrowed among EMU nations (as well as among some non-EMU nations), reflecting the disappearance of currency risk as well as cross-national fiscal consolidation. These spreads, however, have not disappeared fully: member states continue to pay different borrowing rates, although the spreads among them rarely exceed 50 basis points (0.5%).

The persistence of interest rate differentials reflects the emerging (albeit still minor) salience of default risk, as well as low liquidity in some markets (Lemmen and Goodhart, 1999). Provided that Article 104b of the Maastricht Treaty (the 'no bailout' clause) remains credible, default risk becomes more salient. Investment analysts anticipated this in 1997 and 1998:

> 'There is no default risk when the government runs its own printing presses, so the risks associated with bonds will change with EMU. The foreign exchange and inflation risks will disappear, but the default risk will emerge. And countries facing market discipline could have greater instabilities.'
>
> '[EMU] means looking at default risk, something that doesn't get much attention right now . . . but it will come back post-EMU, as market actors worry about the potential effects of asymmetric shocks, and about disparities in growth in Europe.' (Interviews with fund managers, 1997 and 1998)

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The prevention of excessive debt, of course, underpins the Stability and Growth Pact (SGP). Governments, particularly in Germany, wanted to insure that a profligate government would not threaten the euro zone (Brunila et al., 2001). If a government believes that its partners or the ECB will keep it from default, it has an incentive to spend and borrow excessively – a problem of moral hazard. Such a government also might demand an *ex ante* (by keeping interest rates artificially low) or an *ex post* (by monetizing government debt) bailout (Buiter et al., 1993; Crowley, 1996; Eichengreen, 1992). Or a government might even ask other members to help repay its obligations. These events could cause a fall in the euro's value and a rise in interest rates for the entire euro area. Furthermore, an actual default could spread financial problems into domestic financial systems. Member governments addressed this problem via a legal, rather than a market-based, route by signing the SGP at the June 1997 Amsterdam summit. The SGP includes both preventive measures – governments must submit their proposed budget programs to the Economics and Finance Council of the EU (EcoFin) – and punitive measures – excessive deficits can generate warnings and ultimately fines.

An effective SGP would render the no bailout clause of the Maastricht Treaty redundant. The SGP's design and recent history, however, leave this an open question: its penalties for excessive deficits are slow and small to accrue, and plenty of room remains for political interpretation (Crowley, 2001; Mosley, 1999). It is difficult to imagine countries, particularly France and Germany, voting to fine themselves. Yet, not fining oneself in the face of persistent violations would further diminish the SGP's credibility. Additionally, the SGP focuses on total rather than on structural deficits; this can generate excessive stringency and, ultimately, political resistance to the Pact (Brunila et al., 2001).

With the suspension of the SGP in November 2003, its credibility is very much in question. Commission President Prodi labeled the Pact as 'stupid' in October 2002. Portugal breached the 3% deficit limit in 2001, and avoided doing so in 2002 only with dramatic budget cuts.[8] Germany breached the limit in 2002 and 2003, and may do so again in 2004; the European Commission formally censured Germany for its excessive deficit in January 2003. Similarly, France has promised to comply with the SGP by 2005, but only after three consecutive years (2002–4) of excessive deficits. France's violations of the SGP, however, were kept off EcoFin's agenda for its October 2003 meeting, and the November 2003 meeting culminated in a decision not to press France and Germany on their deficits. Italy, too, appears on track to violate the 3% limit in 2004.

More generally, the fact that most euro zone nations missed their 2002 budgetary and debt targets implies a slowing of the decline in public debt in

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EMU nations (ECB *Monthly Bulletin*, September 2002). Italy's debt level, for instance, has moved toward 110% of GDP. In late 2002, the Commission discussed a new approach, in which the 3% deficit limit would remain in place, with governments obligated to cut structural deficits to 0.5% of GDP, while the aim of budgetary balance over the medium term would be deferred from 2004 to 2006 (*European Report*, 28 September 2002: 225; *Financial Times*, 24 September 2002). In autumn 2003, the French government called for greater flexibility in the interpretation of the SGP, and the IMF's Chief Economist suggested that the SGP ought to be applied differently in the future. Governments of smaller EU members (Austria, Greece, Ireland, the Netherlands), however, have opposed any changes to the Pact, and have called for strong disciplinary action against habitual offenders. The finance ministers and central bank directors of several central European nations also have staunchly opposed any revisions of the SGP, because they hope to use the Pact to promote fiscal discipline once their countries join the EU.

The impasse regarding the SGP may provide markets with more reason to worry about default and, therefore, about the ways in which governments allocate their spending across functional areas or respond to calls for structural reform. Financial market participants interviewed in October 1998 were skeptical about the ability of the SGP to induce fiscal discipline. Some worried that governments might use overly optimistic budget projections, or one-off revenue-producing measures, as ways of meeting fiscal targets (also see ECB *Monthly Bulletin*, October 2002). More recently, the German business daily *Handelsblatt* observed that 'credibility is vital to the pact, but . . . that credibility is damaged more than ever before' (*New York Times*, 19 October 2002).

During 2002, interest rate spreads increased for the four SGP 'violators' or 'near violators,' suggesting some sensitivity to fiscal policy outcomes under EMU. Table 1 lists the spreads between the bonds of the US government and those of the governments of Germany, France, Italy, and Portugal at the beginning and end of 2002. Although spreads were small or even negative at the start of the year, they became positive for all four nations. Germany, long the benchmark European bond issuer, saw its rates least affected. In June 2003, Fitch Ratings noted the excessive German deficit, but affirmed Germany's AAA rating, suggesting that 'it will be some years before these weaknesses begin to seriously erode Germany's creditworthiness' (AFX.com, 17 June 2003). France and Portugal, on the other hand, saw noticeable increases in spreads; Portugal's were close to 100 basis points in the fall of 2002, before it launched its fiscal austerity program. Although these differences may reflect a variety of factors (such as investors' optimism regarding the US versus European economy), they also point to increased market concerns about credit risk. EMU's effectiveness hinges on its ability to achieve consensus on

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Table 1 Interest rate changes, SGP 'violators', 2002 (%)

Country	*Spread vs. US government bonds, January 2002*	*Spread vs. US government bonds, December 2002*	*Change in spread, January to December 2002*	*Spread vs. German government bonds, December 2002*
Germany	–0.13	0.01	+0.14	–
France	–0.06	0.43	+0.49	0.42
Italy	0.15	0.57	+0.42	0.56
Portugal	0.10	0.57	+0.47	0.56

economic policy coordination; without this, risk among members will again diverge.

The potential salience of default risk also is evidenced in sovereign credit ratings. In late 1997, the 11 future EMU members shared a long-term local currency rating of AAA, the highest sovereign debt rating (Standard and Poor's *Creditweek*, 5 November 1997). Despite the variation in levels of debt and, to a lesser extent, deficits, their benchmark government bonds were treated as virtually risk free. Governments' ratings for foreign currency issues were more variable, ranging from AA- in Portugal to AAA in Austria, France, Germany, and the Netherlands, reflecting the higher risk associated with foreign currency-denominated debt. When EMU membership was announced in May 1998, some of the major ratings agencies collapsed members' local currency and foreign currency ratings into a single measure. As a result, most ratings fell: in late 1998, five of the EU11 received an AAA rating from Standard and Poor's: Austria, France, Germany, Luxembourg, and the Netherlands. The remaining six countries received ratings of AA+ (Belgium, Ireland), AA (Finland, Italy, Spain), or AA- (Portugal).[9] Ratings agencies judged these nations to have slightly higher default risk. In its October 1999 discussion of Belgium's rating, for instance, Standard and Poor's noted that Belgium's 'high public debt burden still constrains its long-term rating' (Standard & Poor's, *Belgium – Sovereign Rating*, October 1999).

Continued divergence remains, as Table 2 illustrates. Of the 15 EU members, 9 (including Luxembourg) are rated AAA; these include 7 EMU participants. Others are rated AA or AA+, and Greece is rated A+. The most recently AAA-rated member is Finland. This reflects 'the government's success in strengthening fiscal flexibility, its commitment to continued fiscal discipline, and a solid macroeconomic policy record underpinned by Finland's participation in EMU' (Standard and Poor's, *Finland – Sovereign Rating*, 1 February 2002). Similarly, Greece's admission to EMU at the start of

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Table 2 Sovereign ratings and government bond spreads, 1998 and 2003

Country	*Interest rate on benchmark government bond, August 2003*[a]	*Standard and Poor's long-term rating (foreign currency), September 1998*	*Standard and Poor's long-term rating (foreign currency), September 2003*	*Spread versus German rate, September 1998*[a]	*Spread versus German rate, August 2003*
Austria	4.24	AAA	AAA	–0.03	0.04
Belgium	4.26	AA+	AA+	0.20	0.06
Denmark	4.39	AA+	AAA	0.52	0.18
Finland	4.23	AA	AAA	0.34	0.03
France	4.23	AAA	AAA	0.29	0.02
Germany	4.20	AAA	AAA	–	–
Greece	4.12[b]	Not rated	A+	4.26	0.33[b]
Ireland	4.17	AA+	AAA	0.57	–0.03
Italy	4.34	AA	AA	0.54	0.14
Netherlands	4.21	AAA	AAA	0.52	0.01
Portugal	4.10[b]	AA–	AA	–0.01	0.31[b]
Spain	4.25	AA	AA+	0.25	0.04
Sweden	4.56	AA+	AA+	0.83	0.36
UK	4.67	AAA	AAA	1.07	0.48

Notes:
[a] Data on interest rates and spreads are rounded to two digits.
[b] Data are for July 2003.

2001 was accompanied by upgrades (from A- to A) from various credit ratings agencies; a further upgrade, to A+, occurred in June 2003. Although EMU membership is not necessary for an AAA rating, as Denmark and the UK demonstrate, it may be an additional 'seal of approval' for peripheral European nations. Interest rate spreads among countries and even among similarly rated borrowers persist, but these spreads have decreased in most countries, as the last two columns of Table 2 indicate.

The correlates of government bond rates provide a final piece of evidence about post-EMU default risk. Generally, there should be a positive relationship between the size of public debt and interest rates, and a negative relationship between fiscal balances and interest rates (surpluses generate lower rates, whereas deficits produce higher ones). These relationships hold for EMU members during the period from 1995 to 2002. Bond rates are correlated positively with public debt ($r = .24$; $n = 97$) and negatively ($r = –.57$) with fiscal

balances. These associations, however, are weaker after 1998: the correlation for debt and interest rates falls to .10 (for 1999 to 2002), and the correlation between fiscal balance and interest rates changes sign to .17. The latter may reflect the fact that France and Germany, which typically pay lower interest rates because of their benchmark status, also have had relatively large deficits. But the differences also highlight the possibility that fiscal outcomes generate less of a market response after EMU, giving some credence to Restoy's (1996) prediction that high-debt nations can borrow more cheaply after monetary union. This also hints that improvements in liquidity and currency risk may offset increases in default risk, or that market participants believe that bailouts remain an option.

Implications for the post-EMU world

To what extent, then, does EMU mark a breakpoint in financial market–government relations? Some observers have suggested that the market for government debt in the euro zone might come to resemble the market for state-level debt in the United States, or, perhaps more accurately, the market for provincial debt in Canada (Gros and Lannoo, 2000). US states and Canadian provinces with higher levels of debt tend to receive lower credit ratings and pay higher rates of interest. In many cases, though, these premia are quite small (Bayoumi et al., 1995; McKinnon, 1997; Restoy, 1996).

There is some possibility that default risk is salient – or at least *more* salient – to investors after EMU. Although some market participants claim that market reactions are not nearly as severe as they could be, and some observers note that financial market discipline alone will not prohibit fiscal deficits (Reuter's, 7 June 2002), the ultimate impact of EMU on investment risk considerations remains to be seen. It may hinge on the way in which the impasse over the SGP is resolved, as well as on the ways in which policy-makers respond to impending demographic and structural economic pressures. If the Pact dissolves entirely or if the Pact remains in place in its current form, market participants are likely to take default risk more seriously, and governments with higher debt and deficit levels can expect to see their borrowing costs rise. They also might expect financial market pressures to increase in scope, as investors come to make more rigorous comparisons between national micro-policies.

If, on the other hand, member governments succeed in reformulating the Pact, possibly allowing for variations over the economic cycle, market participants may see governments' commitments as credible and realistic.[10] In this case, default risk will continue to be a low-level consideration for investors and governments will reap lower interest rates as a result of EMU

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membership. If borrowing costs fall, funds previously used for interest payments can be used for other purposes. Therefore, while the emergence of default risk could preserve differences among EMU nations, overall trends in debt could facilitate a general lowering of rates: even if Belgium pays more to borrow than Germany, both will pay less than they did five or ten years ago.

Financial markets and EMU membership: Lessons from an 'out'

What does the above discussion imply for those nations – the three 'outs' and the new EU members – contemplating membership in EMU? To what extent and in what ways would joining EMU change governments' interactions with international capital markets? Membership in EMU is bound up with larger issues, such as public attitudes toward the EU generally, and concerns about the creation of a two-speed Europe. At the same time, however, membership in EMU may affect governments' capacity to access international financial markets and to pursue domestically determined social policies. Although the governments of the three current 'outs' support EMU membership, they worry about the lack of public support. The recent debate over the SGP, as well as the 'no' vote in Sweden's September 2003 referendum, may reinforce anti-EMU voices in Denmark and the UK. One important issue, in this respect, is the extent to which EMU membership serves to exacerbate *or* to mediate pressures from the global economy.

To provide a detailed answer to these questions, we could rely on comprehensive case studies of policy-making in both EMU and non-EMU nations, or before and after EMU within particular members. These case studies would draw on archives and interviews with policy-makers, and they would provide some evidence about the way in which EMU specifically, rather than global financial markets generally, affects policy-making. This task, however, is beyond the scope of this article. Here, I consider the policy-making experience during the past decade of one of the 'outs' – Sweden – and how this experience might affect its choices over EMU. Sweden's economic size and degree of political influence render its experience very relevant to the EU's 10 new members.

In the early 1990s, prior to EU membership, Sweden was characterized by high and growing debt, a fragile economy, and large interest rate premia. Facing these problems, the Social Democrats (SDP) stabilized public debt and reduced fiscal deficits, while maintaining welfare state provisions. Sweden's economic policy in the mid-1990s was more about cutting the costs of

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programs and expanding state revenue than about eliminating entire programs or reorienting the general degree of welfare statism (Iversen, 2000; Moses, 2001; Pierson, 2001; Stephens et al., 1999). The SDP emphasized that sound public finances were necessary for the preservation of the welfare state (Hallerberg, 2004). It was not only that international markets were pressuring Sweden, but also that – by virtue of its past policies – Sweden was pressuring itself.

This pattern is consistent with the 'strong but narrow' view of financial market influences, as well as with a view that emphasizes the interaction of domestic with international pressures (Huber and Stephens, 2001; Notermans, 2000; Swank, 2002). In Sweden, public opinion and electoral competition were particularly salient (Iversen, 2000; Kitschelt, 1999); SDP strategy aimed at balancing between international and domestic pressures. In the run-up to the 1998 election, and facing its lowest level of approval for decades, the government focused on the domestic dimension. Its budget included increased funding for many social services and education programs. Ultimately, these proposals were not enough to prevent continued voter defections to other left parties, but they demonstrate the mediation of financial market pressures by domestic politics (Huber and Stephens, 2001). More recently, Sweden has transformed itself into a strong economy with higher growth and lower unemployment than most euro area nations, and with a much-improved fiscal position. Despite some recent deregulation, the government continues to finance health care, education, and many social services.

The experience of the 1990s suggests that international markets will influence Sweden's policy choices, whether it is in or out of EMU. Even without the SGP, for instance, overall limits on the government's ability to borrow persist (Pierson, 2001). For example, the 2002 budget aimed for a surplus in public finances, as well as increased revenues with which to fund public expenditures (Swedish Ministry of Finance, 'The Budget Bill for 2002'). This, again, fits with financial market views of government policy in the pre-EMU world: if governments are able to fund generous public sectors, markets are willing to allow them to do so (interview with senior Swedish finance ministry official, May 2002). Moreover, Sweden is employing debt management tools as a means of reducing vulnerability to financial market pressures (Piga, 2002); it has reduced its use of foreign currency denominated debt and is aiming to increase the average time to maturity of its public debt.

To what extent would EMU membership facilitate Sweden's achievement of its financial-market goals? In Table 2, we can compare the interest rates paid by Sweden recently with those paid by Finland and Ireland. Both Finland and Ireland were in similar fiscal positions (with budgets in or near surplus in 2001 and 2002, and a moderate and declining level of debt), although

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Ireland and Finland had slightly higher inflation in recent years. In August 2003, Sweden paid 39 basis points (0.39%) more for benchmark bonds than did Ireland, and 33 basis points more than Finland. Both Finland and Ireland received an AAA credit rating for foreign currency issues, whereas Sweden's is AA+. Similarly, Figure 3 displays more recent government bond rates among a select group of European nations – Germany, Finland, Greece, and the EMU 'outs.' This figure again indicates convergence (and co-movement) among rates. This may suggest that Europe is becoming more of an optimum currency area, but also that EMU per se is not necessary for financial market benefits. It is also interesting to note that, among non-EMU members, Sweden and the UK currently pay the highest borrowing rates, approximately 30 to 40 basis points above Germany's. This spread is smaller than in the past (e.g. from 1995 to 1997, when spreads reached over 300 basis points), but larger than that between Germany and other small EU nations.

A key question for Sweden, then, might be the extent to which the potential savings in terms of interest rates justify the economic constraints imposed by EMU. Of course, the decision regarding EMU membership in Sweden is rooted as much in domestic politics as in international economic considerations. Domestic considerations include organized labor's skepticism regarding the importance of price stability (Aylott, 2001) and divisions between export-oriented and non-tradable industries (Frieden and Jones, 1998). Moreover, Sweden's history is one of maintaining an autonomous monetary policy and of using exchange rate adjustments as a means of solving economic crises (Iversen, 2000; Moses, 1998; Notermans, 2000). The September 2003 referendum, in which 56% of the public voted against the single currency, may have been as much a vote on the EU generally as on monetary union specifically. The issue of EMU is likely to remain a difficult one, particularly when Sweden's economic performance outpaces the euro zone's, as it did in 2003.

These facts notwithstanding, EMU appears to have played a relatively small role in Swedish policy during the past decade, despite the government's legal commitment to join. The fiscal policy criteria pushed the Swedish government in the same direction that international financial markets and domestic economic crises were pushing. But the major changes in the budgetary process came relatively early, i.e. in the early and mid-1990s. EMU might have provided a useful scapegoat for some political actors, but it likely did not drive their choices. Today, EMU offers benefits such as reduced inflation risk, but these benefits might be offset by a premium for increased default risk. EMU may also offer stability to governments in times of financial crisis, as it seemed to do for Finland in the fall of 1998. But, as its opponents undoubtedly point out, other means – such as certain types of debt management strategies – also can provide insulation from financial market pressures.

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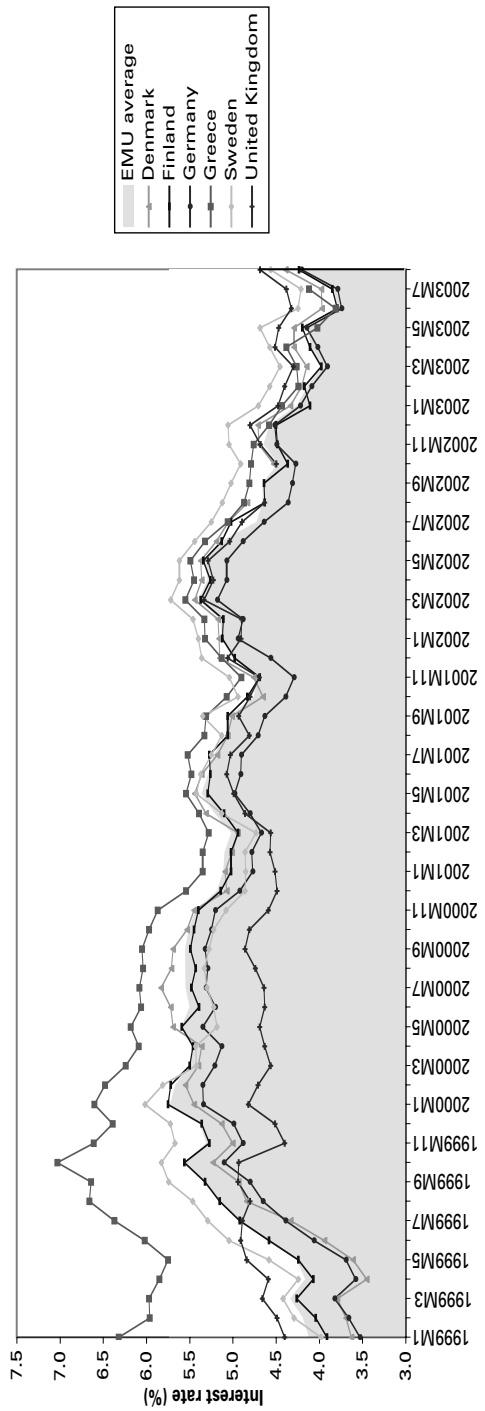

Figure 3 Government bond rates after EMU.

The costs of EMU for Sweden appear modest, given earlier changes resulting from financial market pressures; but the benefits also may be modest.

More broadly, the Swedish case illustrates the importance – analytically as well as politically – of distinguishing between national policy changes that happen at the same time as movements toward EMU and those that are the direct result of EMU. Pressures for fiscal retrenchment may be just as rooted in international capital markets generally (affecting any nation that is open to external investment flows) as they are in EMU, and in domestic politics, specifically. As recent events in Europe have indicated, when national governments (particularly of large states such as Germany and France) face a choice between upholding their external SGP commitment and implementing their favored domestic economic policies, they often will choose the latter. German Chancellor Schröder, for instance, remarked in June 2003 that he was willing to breach the SGP if that was necessary to increase economic growth and decrease unemployment (*Financial Times*, 5 June 2003). EMU does not alter fundamentally the extent to which, for example, pension reform is a contested domestic issue in France.

Furthermore, a recent study of fiscal policy-making in the developed world (Gali and Perotti, 2003) finds that EMU-related limits have played a very minor role in fiscal policy outcomes: there are global trends toward more countercyclical fiscal policies, as well as toward declining public sector investment. The former occurs in EMU members, non-EMU members, and non-EU countries alike, whereas the latter trend manifested itself before the signing of the Maastricht Treaty. The existence of these patterns across OECD nations may highlight the influence of international capital markets generally, but the relative lack of influence of EMU (or the SGP) specifically. This reality, though, may be quite at odds with public perceptions of EMU influence in the 'outs.'

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Conclusion

The advent of EMU generated several changes that could alter the tenor of government–financial market relations; these include the decline of resident investment, the elimination of currency risk within Europe, and the increased salience of default risk. As the Swedish case illustrates, however, the overall impact of these changes is thus far modest. On the one hand, EMU governments now borrow in a 'foreign currency,' and this could exacerbate perceptions of default risk. But, on the other hand, financial markets reward governments for the fiscal consolidation and increased market liquidity that flow from the single currency. As a result of these offsetting effects, there have been no dramatic changes in financial market–government relations.

Although EMU provides other types of benefits for governments, its impact on financial market–government interactions is modest. Governments continue to face external pressures on domestic policy-making, but these pressures may be only slightly more severe for EMU than for non-EMU countries. As a result, decisions about future accessions to EMU are likely to reflect domestic politics (including a potential desire to tie further the hands of future fiscal and monetary policy-makers) and intra-European politics rather than financial market pressures. At the same time, the future pattern of financial market–government relations in Europe depends, to some extent, on the future of the Stability and Growth Pact. Continued concerns over its unenforceability, coupled with continued fiscal deficits in many countries, could serve to increase the interest rate premia charged to governments.

Data Appendix

Budget balance	OECD, *Economic Outlook* and IMF, *International Financial Statistics*. 2002 and 2003 data are from national convergence programs, available at http://europa.eu.int/comm/economy_finance/about/activities/sgp/scplist_en.htm.
Interest rates	Monthly and annual interest rate data are for 10-year government ('benchmark') bonds, from Datastream. From October 2002, data for Greece are from the Bank of Greece, www.bankofgreece.gr/en/. From March 2003, data for Portugal are yield on treasury bonds, secondary market, 10 years to maturity, from the Bank of Portugal, http://www.bportugal.pt/stats/html/BE_INDb10_e.HTM. EU-wide and EMU-wide averages are unweighted means.
Public debt	IMF, *International Financial Statistics*. Data for 2002 and 2003 are taken from national convergence programs, available from EcoFin,
Non-resident investment	OECD (2003); percentage of marketable central government debt held by resident and non-resident investors.
Sovereign credit ratings	Long-term foreign currency ratings at the beginning of each month, from Standard and Poor's *Creditweek*.

All data used in this paper are available, upon request, from the author.

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Notes

1 The 'varieties of capitalism' approach to divergence (e.g. Hall and Soskice, 2001; Kitschelt et al., 1999) posits that different economies are organized along different institutional lines, and that these varying complexes of institutions create and sustain diverse political and economic profiles. The 'domestic political processes and institutions' view of divergence (e.g. Garrett, 1998; Swank, 2002) focuses on the ability of domestic interest groups, ideologies, and governmental institutions to mediate between the international and domestic spheres.

2 Data on non-resident investment are available for nine EU nations. The correlation between non-resident investment and government debt is (r = –.36).

3 Liquidity problems are exacerbated by the general trend toward falling public debt (and, therefore, fewer government bond issues) in the OECD. See Favero et al. (2000); Galati and Tsatsaronis (2001); OECD (2002a, 2002b). Codogno et al. (2003), however, argue that yield differentials among euro zone borrowers are due not to liquidity risk but to default risk.

4 Data, for July 2003, are taken from www.ecb.int/stats/sec/sec.shtml.

5 Investors might also diversify away from government bonds and toward corporate bonds. See OECD (2002a).

6 Other average maturities are 4.2 years (Austria, Portugal); 4.8 (Belgium, Finland); 4.9 (Spain); 6.3 (France); and 6.8 (Netherlands). Data are for the end of 1998; from Deutsche Bank Research, *EMU Watch* 79, 25 November 1999.

7 Falcetti and Missale (2000) suggest that recent declines in foreign currency denomination and in the issuance of short-term debt in OECD nations are due to increases in national central bank independence. Debt management is a second-best route to anti-inflation credibility, whereas central bank independence is a first-best route.

8 EcoFin had initiated the excessive deficit procedure against Portugal earlier in 2002, but Portugal managed to meet the 3% limit in December.

9 Standard and Poor's *Creditweek*, 4 November 1998; 3 November 1999; 1 November 2000. Finland's rating was upgraded to AA+ in 1999, as was Spain's.

10 UK Chancellor Gordon Brown suggested similar reforms, as well as an allowance for borrowing to fund investment, in October 2003. Similarly, Commission President Prodi proposed added flexibility for the Pact, plus allowing the Commission to issue early warnings to member governments directly (without approval of Ecofin).

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