PUBLIC DEBT AND SHIFTING OF THE DEBT BURDEN FROM ONE GENERATION TO THE NEXT

Further considerations:
do outright monetary transactions (OMT) comply with the EU Treaty?

In connection with the immensely increasing public debt both within the European Union and in other leading industrial countries of the world, reproaches are made again and again that this constitutes also an increasing burden for the future generations of the population of these countries. Such generalisations are wrong, however. Objective treatment of this problem requires differentiated consideration. We should keep public debt owed to domestic creditors (internal public debt) strictly separate from that owed to foreign creditors (international public debt) in these countries regardless of whether the creditors are natural or legal persons.[1]

If the creditors of the public debt are domestic creditors, the domestic financial assets are increasing. If the population holds public bonds, it becomes the creditor for the state, i.e. the creditor for itself. *Summa summarum* such financial transactions do not change the financial situation of the national economy. Public debt is set off by the equivalent fictitious financial assets held by domestic investors. „The people on the whole do not become richer if the financial capital is grown through the acquisition of public bonds, and *vice versa* – they do not become poorer if this increases the public debt as this is another aspect of the same process.“[2]

How to assess the situation which will develop years later when the state will have to repay the debts? Will redemption of the public debt create an additional burden for the generation who will have the obligation to repay it?

Let us assume that the state will not be able to finance repayment of the debt from the current state revenues in the future. Then the state will have to raise taxes to be able to repay its debts. The citizens of the state will then indeed have to bear the burden of additional taxes. But who will benefit from the repayments in such a situation? Surely, the same generation which is burdened with additional taxes!

[1] The concepts *internal public debt ↔ international public debt* have to be kept separate from the pair of concepts *implicit ↔ explicit national debt*. The following thoughts are based on the actual deficit *expressly* stated in the state budget. Implicit public debt, on the other hand, is just forecasted deficit which has not become a reality yet but may arise on the basis of effective legislation (in connection with the disbursement of pensions of government officials, social benefits, e.g. pension insurance, health care benefits, long-term care benefits and other payments guaranteed by the state), in connection with expected demographic changes (population, age structure) and considering the development of public revenues. Thus the social benefits and the required additional state expenditures will increase and also changes will be made in their financing (increasing of social benefits and/or taxes, explicit national debt), which will concern only the next generations and will not lead to the immediate shifting of the debt burden in that sense.

[2] Donner, O., Grenzen der Staatsverschuldung. Weltwirtschaftliches Archiv, Volume 56, 2 (1942), pp 183 *et seq*.

„Money is actually moved only from one pocket to another“[3]. All in all, in the case of domestic debt – apart from the possible impact on economic growth meanwhile – *ceteris paribus* (all other things being equal), the total amount of money available to the population will not change in any way.

The description presented above certainly does not exclude any severe impact of changes in the redistribution system of the private sector which concern many people. This will happen if the economic agents who actually have to bear the additional tax burden are not the same persons to whom the public bonds will be repayed.[4] The purchasing power of the national economy as a whole will not decrease, however. Thus us we can state the following: shifting of the debt burden from one generation to the next will not depend on the existence of the public debt to the extent that public bonds are acquired by domestic economic agents. The same applies to the payment of interest by the state to holders of bonds.

The situation may be different if public debt is acquired by foreign buyers. Now the debt repayment and interest obligations will be to payees who are abroad. If such payments cannot be made in due time from current public revenues, the taxes will have to be raised. Such a trend may decrease the potential living standards of the particular generation of taxpayers.

To what extent it will actually happen in mid-term or long-term will depend on the purposes for which the state uses its purchase power achieved with the assistance of debts. If it is predominantly used for consumption purposes, e.g. for current public expenditures[5] and purchasing of arms, it will really burden the future generations without giving them any benefit.

On the other hand, if expenditures financed with public debt are used above all for projects intended for the future, such as infrastructure expenditures in the broadest sense[6], such expenditures will increase the growth potential of the national economy. If it will lead to future economic growth, it will benefit the future generations. Consequently, such use of funds will shift the debt burden from one generation to the next only if the subsequent absolutely necessary increase of the tax burden is perceived higher than the increase in welfare achieved on the basis of the economic growth.

With the outburst of the debt crisis within the European Union, the European Central Bank (ECP) first started to buy Greek bonds from the after-market from May 2010 through outright monetary transactions (OMT), then also Irish and Portuguese bonds and from August 2011 in addition also Italian and Spanish bonds. By February 2012

[3] *Idem*, p. 185.
[4] Think about the clearly decreasing impact of value-added taxes, particularly concerning food products.
[5] For instance, on salaries, state pensions, pensions not covered by contributions.
[6] Such as expenditures on education, scientific research and development activities, communication equipment, road construction.

the total volume of these bonds had increased to 219.5 billion euros.[7] The objective of this novel measure was to assist the countries in trouble for the moment to decrease their financing costs.[8] From the aspects of „the generation“ of single countries, the European Central Bank should be viewed as a foreign institution. In that respect the statements provided above apply.

As to outright monetary transactions, their closer review raises the question of whether the described activities of the ECP are still included in its mandate. According to Article 123 of the EU Treaty, any favouring of Member States in providing loans is expressly prohibited to the ECP. This means that the Central Bank is not allowed to provide directly any ECP credit facilities to EU Member States. Otherwise there is the risk that the inflation potential that would develop in the course of time may become unmanageable. Besides, such financing opportunities would make it possible to exert pressure on governments to perform structural reforms in the areas of industrialisation, infrastructure and labour market, and there would be no pressure to decrease the accumulated debts.

It is worth finding out whether Article 123 of the EU Treaty prohibits the European Central Bank to buy also bonds already issued. In addition it would be necessary to find out whether this prohibition applies also to the bonds of countries which comply with the conditions of the European Stability Mechanism (ESM)[9].

An important question should be asked, bearing in mind the ultimate duty of any central bank: are the economic difficulties of the countries in crisis, which the ECP makes efforts to fight by way of outright monetary transactions, signs of disorders in monetary policy transmission, or are these economic problems, particularly fundamental structural problems of these countries? In other words: is the ECP trying to paralyse disorders in the interactions in the chain of monetary policy instruments[10] by buying already issued bonds in order to increase or at least maintain the efficiency of the measures, or is the Central Bank indirectly financing the countries with its outright monetary transactions, ignoring Article 123 of the EU Treaty?

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[7] Source: EZB

[8] It is questionable whether ECP will achieve this also after 2013 and 2014, after the Chairman of the Board of Governors of the U.S. Federal Reserve System declared the imminent end to the current low-interest policy, although only in case of positive developments of the economic and employment growth in the U.S.A. And more: „The duties of the Central Bank do not include blocking higher risk premiums.“ (Jürgen Stark (Economist of the ECP from June 2006 to September 2011) – a quote from his interview to the German newspaper *Handelsblatt*, 26.07.2013, p. 24 *et seq*.)

[9] According to this reform programme (Secondary Market Support Facility, briefly SMSF), ESM makes it possible to buy government bonds in the after-market and namely in unlimited amounts.

[10] Measures of monetary policy → instrument variable (monetary base = amount of funds of the Central Bank) → target variable (interest rate) → ultimate goal (price level stability)

At any rate, the purchasing activities of the ECP – and this should be understood – are accompanied by unforeseeable common risks. The fact that the dramatic increase in the amount of funds of the ECP due to outright monetary transactions during the first round of purchases has had as yet no impact on inflation does not prove that ECP was indeed only trying to eliminate problems from the interactions of monetary policy. ECP performs its outright monetary transactions (OMT) „in the gray zone somewhere between monetary and fiscal policies.“[11] Where does monetary policy end and fiscal policy begin? These issues are currently subjects of heated disputes and controversies. There is no general answer for them and also courts cannot decide them.[12] Answers can in principle be found only in a specific situation and by taking into account specific macroeconomical framework conditions.

August 2013

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[11] Clemens Fuest (Centre for European Economic Research) before the Constitutional Court of Germany in Karlsruhe on 11 June 2013.

[12] It would actually make no sense to present this issue to the Constitutional Court of Germany for adjudication as this court is not competent to give instructions to the ECP. Only the European Court of Justice in Luxembourg could issue a judgment in this issue and only provided that the judges and their consultants have the required technical knowledge.