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Monetary Union Impact on Government Debt Lessons for European Monetary Union Enlargement

Von *Philipp Paulus*

Will government debt rise or fall in a monetary union? This study attempts to provide answers, in particular for the case of the European Monetary Union and for those countries that intend to join it. Given that the global financial crisis that started as a subprime crisis in the US in 2007 also affects government budgets and the efficiency of capital markets, some insights are provided from this perspective as well.

Research so far on this subject has mostly focused on government behaviour, including strategic elements of its relationship with other governments, as well as the union central bank. It is equally interesting, though, to also analyse in this respect the effects of a monetary union on the macroeconomic environment as well as on capital supply, since, eventually, the level of government debt is the outcome of a market.

Various reasons are identified – both theoretically and empirically – which illustrate that a monetary union can indeed lead to lower levels of government debt. However, an appropriate economic policy framework is of key importance. Government demand for debt must be limited through fiscal rules like the Stability and Growth Pact, but capital supply should likewise be regulated, and in such a way that capital markets can show the disciplining effect that is probably enhanced by a monetary union. At the heart of all considerations is the role of the union central bank – for the euro area: the European Central Bank. It needs to be made certain that it has all necessary means available to handle the dilemma of needing to preserve price stability on the one hand, and not support profligate governments on the other.

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