Should the European Stability and Growth Pact be Relaxed?

In view of the recent dramatic deterioration of the economic outlook, fears have been voiced that the European Stability and Growth Pact may not leave enough room for fiscal stabilisation policies, preventing the automatic stabilisers from taking effect and dampening growth-enhancing public investment. Should the Pact be revised to provide more flexibility in a cyclical downturn?

Ray Barrell*

Time to Consider Alternatives to the Stability and Growth Pact

Consolidation of the public budgets has become the most important fiscal policy goal pursued by the EU member states in recent years. This commitment is embedded in the criteria in the Maastricht Treaty and the Stability and Growth Pact. It is perhaps time to consider alternatives that relax the guidelines of the Pact, allowing economies to strengthen responses to recessionary impulses such as those embedded in automatic stabilisers and also giving space for public investments that would enhance growth.

The Golden Rule and Public Investment

The Maastricht Treaty formulated the goal of a budget deficit of less than 3 per cent of GDP, based in part on the golden rule of public finance that allows borrowing to finance productive investment. In the run up to the Treaty the public sector in the Euro Area as a whole (as can be seen from Figure 1) had been investing as much as 3 per cent of GDP in infrastructure, and the golden rule would allow borrowing up to this amount. However, the 1990s saw a marked reduction in public sector investment as part of the consolidation process. This is expected to continue as the Stability and Growth Pact (SGP), with its plan for budgets in balance or surplus over the cycle, is implemented.

Public investment in infrastructure has often been a prime target for budgetary cuts despite the wider evidence that such a policy might reduce the potential for growth in the European economy. The requirements of the Stability and Growth Pact may well pose a constraint on public investment over the next few years when there is an urgent need to increase it from the low levels experienced in the last few years. If there were to be a revision to the guidelines one obvious benefit would be to allow for more investment. Indeed, enshrining a version of the golden rule into European treaties, much as in the German constitution, might be wise.

The target in the Stability and Growth Pact is much tighter than in the Maastricht Treaty. The objective of "in balance or surplus" was designed in the run up to Monetary Union in order to ease the process of financial convergence and meet political worries in countries such as Germany. The discipline is now embedded in the Treaty with regularly revised plans. Every year each EU country is required to produce a stability or convergence programme, presenting the main fiscal decisions and budgetary choices on the path to medium term objectives for budgetary

* Senior Research Fellow, National Institute of Economic and Social Research (NIESR), London, UK.

Figure 1
Public Sector Investment as a Percentage of GDP

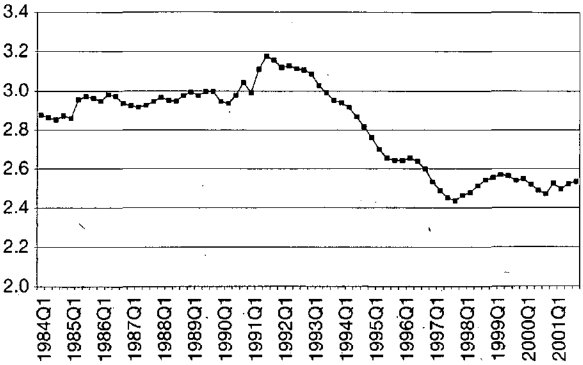
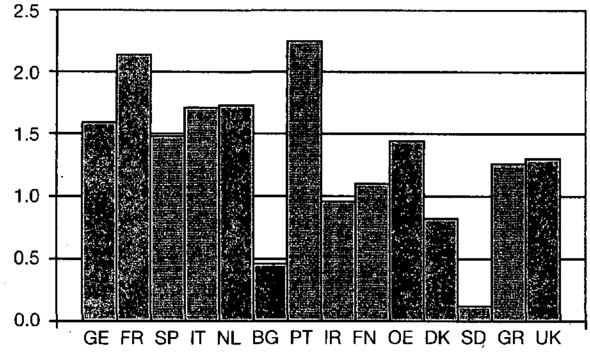


Figure 2
Target Deficit Required for a 1% Chance of Breaching the 3% Limit



positions close to balance or in surplus. These programmes constrain fiscal policy options.

The decision to put further constraints on the potential for public borrowing was clearly wise in the early period of construction of Monetary Union in Europe. However, it is worth discussing alternatives to the SGP, looking in particular at the sustainability of public finances in the European Union and at the role of the public sector in strengthening the prospects for output growth. It is not clear that the SGP is necessarily the best framework for these objectives. There is a very strong case to be made for allowing the public sector to borrow more over the cycle. However, it is clear that moving all the way to the Golden Rule would not be sustainable, and a compromise target could be set, say halfway between the two. Looser targets still mean sustainable public finances, and the consolidation process has inevitably meant that productive expenditures have been cut to meet targets.

Automatic Stabilisers and the SGP

The Stability and Growth Pact has a rather loose system of fines associated with it if deficits exceed 3 per cent of GDP for a sustained period of time. As a result it may be too binding in that governments will be unable to use fiscal stabilisation policies and the 3% ceiling may curtail the workings of the automatic stabilisers in the economy. It is important to calculate the room for automatic stabilisers and to see what deficit targets are needed to avoid the 3 per cent floor to borrowing being breached. Some simple descriptive statistical analyses have been undertaken based on retrospective evidence.

Work by Buti, Franco and Ongena,[1] for instance, broadly suggests that the European economies could operate well within the SGP guidelines if they broadly followed a balanced budget and some, such as the Nordic economies, should aim for a surplus. They suggest that the Finns and the Swedes would have to aim for surpluses of 2.5 per cent of GDP and 1.8 per cent of GDP respectively. The UK, the Netherlands (both -0.5 per cent), Spain (-0.6 per cent) and Denmark (-0.7 per cent) should heed the Commission's desire to keep within a target range of 0 to -1.0 per cent. However, the less volatile or responsive countries could aim for larger deficits than the Stability and Growth Pact suggests. Belgium (-1.4 per cent), Portugal (-1.5 per cent), Ireland (-1.6 per cent) and Germany (-1.7 per cent) could all run reasonable deficits, and the rest of the members of EMU could aim at –2.0 per cent. These results depend on the observed volatilities of both the economies in question and their budget deficits and they probably paint too pessimistic a view of the constraints governments face.

In a study by the present author and K. Dury[2] we use stochastic simulations on our model NiGEM to calculate the target deficit required for there to be only a 1% chance of exceeding the SGP 3% ceiling. The stochastic simulations give us the variabilities of the government budget ratio and from this we can calculate the required mean target for each country. Figure 2 presents these results for each country. We include the UK, Greece and Sweden. Our results suggest that the main European economies can allow automatic stabilisers to operate and also run much

[1] M. Buti, D. Franco, H. Ongena: Budgetary Policies during recessions – Retrospective application of the "Stability and Growth Pact" to the post-war period, in: Recherches Economiques de Louvain, Vol.63, No.4, 1997, pp.321-366.

[2] R. Barrell, K. Dury: An Evaluation of Monetary Targeting Regimes, in: National Institute Economic Review, No. 174, October 2000.

looser deficit targets than in the SGP without risking breaching the 3 per cent floor. Most countries could indeed run an average deficit over the cycle in excess of 1 per cent of GDP and allow the automatic stabilisers to operate. Hence a movement toward higher public sector investment and the implementation of the golden rule of public finance would be possible within the objectives of the current framework.

These results have the advantage of being based on a model of the European economies that we think will exist in the future with a policy environment that is a reasonable description of the current framework. Historically based results depend upon the policies that were in place for the economic structures that existed in the past. They may have no relevance for current policy. Our results should be reasonably robust to criticism of not taking account of structural changes in the economy and in policy regimes. Historical studies cannot be so robust.

If there were worries about the use of fiscal policy for stabilisation the current framework could be amended in a different way from that suggested above. Target deficits of 0 to 1% surplus (as implied by the SGP objective of "in balance or surplus over the cycle") along with our results suggest that there is room for much stronger automatic stabilisers than we have operating. There are three possible effects of the economic cycle on the budget. Tax revenues automatically rise with incomes and expenditures on items such as unemployment insurance automatically fall. These reactions could easily be strengthened, helping to stabilise the level of output in the economy. However, it is common to see that as revenues improve there are political pressures to lean with the wind and cut taxes and raise spending. The first two are best described as automatic stabilisers, but the latter cannot.

Conclusion

Of course reform could combine looser targets and stronger stabilisers, improving the prospects for growth in Europe in the short to medium term. However, the existence of the Pact has to be respected, and the reasons for tight targets understood. The "close to balance" rule can also be seen as being designed to offset some of the potential bias introduced into the budgetary system by bureaucratic offsets discussed, for instance, by Melitz.[3] There is clear evidence that expenditures exhibit a pro-cyclical pattern, as budgetary constraints become looser when revenues are strong. This should mean that the target balance has to be set to take account of the asymmetric nature of the outturns for the deficit, especially if financial market based constraints on government behaviour have been released by the formation of EMU.

We would presume, as in the 1980s and 1990s, governments will find it difficult to run surpluses even when they are appropriate to the cyclical position. Hence a tighter target than that implied in Figure 2 would be appropriate, and it would allow automatic stabilisers to be improved and to work fully in recessions and allow some offset for bureaucratic laxity in upturns. We would conclude that deficits around 1% of GDP would be suitable for almost all countries in EMU.

[3] J. Melitz: Some Cross-country Evidence about Debt, Deficits and the Behaviour of Monetary and Fiscal Authorities, Centre for Economic Policy Research, Discussion Paper Series, No. 1653, 1997.

Thomas Url*

Avoiding Excessive Deficits with Fiscal Coordination Light

The arguments in favour of the introduction of the Stability and Growth Pact (SGP) centre around the issue of the negative external effects of excessive national deficits on fellow member states in the European Monetary Union (EMU) and their feedback on monetary policy through the reduced credibility of the no-bail-out clause. Excessive public sector deficits will – it is argued – *ceteris paribus* create additional demand on the eurozone capital market and thus drive up interest rates for all other members of EMU.[1] The interest-rate channel of excessive deficits relies on the assumption of imperfect capital

* Research staff member, Austrian Institute of Economic Research, Vienna, Austria.

[1] E.g. W. Buiter, G. Corsetti, N. Roubini: Excessive Deficits: Sense and Nonsense in the Treaty of Maastricht, in: Economic Policy, Vol. 16, 1993, pp. 58-100.

markets, where sovereign borrowers on unsustainable deficit paths are not charged sufficiently high risk premiums for possible future default.

Whether this represents a plausible assumption or not may be assessed by comparing risk premiums for individual states of the USA. Bayoumi et al.[2] find moderate default premiums which rise in a steep non-linear way in response to high indebtedness. Thus I conclude the external effects of excessive deficits in the eurozone through rising interest rates may be of secondary importance and do not suffice to motivate the SGP.

The lack of credibility of the no-bail-out clause, on the other hand, may indeed arise from a time inconsistency problem of economic policymaking at the European level.[3] If an EMU member country defaults on its accumulated debt, other participants of EMU may feel obliged to bail out this insolvent government because the associated financial crisis could spread throughout the Union. Thus, if the costs from financial distress outweigh the costs from losing credibility the European Central Bank (ECB) may be tempted to monetise debt from defaulting countries. Further integration of the European financial services sector will amplify the transmission speed of financial crisis throughout the whole Single Market and thus also affect non-members of the eurozone. As in the case of the interest-rate channel, excessive deficits in large members of the eurozone create higher negative external effects for the rest of the EMU as compared to small countries. But as already mentioned by Eichengreen and von Hagen[4] there are more suitable instruments than the SGP to avoid a bail out.

This sort of argument has already been discussed extensively in the literature. I shall therefore concentrate on two related issues of the SGP. First, I will argue that the balanced budget clause should be interpreted as a delegation of discretionary fiscal policy power from the national to the European Union level, and second, I will show that full-scale fiscal cooperation between members of the eurozone is detrimental to the credibility of the ECB, whereas the "coordination light" system established by the budget surveillance procedure according to Art. 103 of the Amsterdam treaty should be welfare enhancing.

[2] T. Bayoumi, M. Goldstein, G. Woglom: Do Credit Markets Discipline Sovereign Borrowers? Evidence from U.S. States, in: Journal of Money, Credit, and Banking, Vol. 27, 1995, pp. 1046-1059.

[3] B. Eichengreen, J. von Hagen: Fiscal Restrictions and Monetary Union: Rationales, Repercussions, Reforms, in: Empirica, Vol. 23, 1996, pp. 3-23.

[4] Ibid.

Delegation Mechanism of Political Power

EMU accelerates the economic integration of European economies. The freedoms of the single market link the product and services markets as well as the labour and capital markets of the Member States. Within this environment households and businesses have increasingly been ignoring national borders in taking economic decisions. Given the elimination of exchange-rate risk and the facilitation of comparison shopping, EMU has amplified the integration effect of the single market and, in addition, has brought a uniform monetary policy for the eurozone. The monetary policy formulated by the ECB also has a strong bearing on the countries not participating in EMU.

In the light of these developments, the opportunities presented to households and businesses are determined increasingly by pan-European market conditions. Similarly the leeway afforded national economic policymakers has been curbed. Varying economic policy objectives, specific national factors and – given diverse economic structures – different transmission mechanisms are juxtaposed by a uniform monetary policy and an increasing body of European Union directives. In line with the statute of the ECB, monetary policy is geared to maintaining price stability in the entire eurozone. The Treaty of Amsterdam introduced an economic policy coordination mechanism between the ECB, the European Commission and the European Council which spells out clear restrictions on discretionary fiscal policy.[5]

Within the restrictions laid down in the SGP, fiscal policy is one of the few economic policy instruments which remain under national control. The leeway accorded governments in formulating tax policy and the scope of spending allows countries to develop their own model of public sector activities, as long as financing is firmly based on current revenues, rather than debt accumulation. In this sense I am inclined to compare the SGP with the Gramm-Rudman-Hollings Deficit Reduction Act in the USA, which commits the federal government to achieving a balanced budget policy by automatically curbing government spending.

[5] F. Breuss: Die Wirtschafts- und Währungsunion und ihre Folgen, in: F. Breuss, G. Fink, S. Griller: Vom Schuman-Plan zum Vertrag von Amsterdam – Entstehung und Zukunft der EU, Vienna, New York 2000, Springer, pp. 273-309.

Consequently, one of the big issues in evaluating the SGP is whether fiscal discipline by national governments in the eurozone is lacking. Persson and Tabellini[6] provide a theoretical model and empirical support for the argument that the dominant political system in the eurozone is prone to establish "large" government. According to their results parliamentary democracies with proportional voting rules produce more public goods, more rents for politicians, more redistribution, and larger government than presidential systems with a majority voting system.

As long as the current constituency fully bears the burden of high taxation, excessive deficits will not emerge. If the high spending level is, additionally, financed by issuing government debt, part of the burden will be shifted to future taxpayers and if those future taxpayers do not form part of the current electorate Persson's and Tabellini's arguments are even strengthened. Under such circumstances a supranational rule like the SGP may provide a feasible instrument for lowering the likelihood of excessive deficits. Holzmann et al.[7] emphasise this aspect and argue that within the eurozone incentives for switching to an unsustainable fiscal policy path will increase due to the loss of taxing power within the

[6] T. Persson, G. Tabellini: The Size and Scope of Government: Comparative Politics with Rational Politicians, in: European Economic Review, Vol. 43, 1999, pp. 699-735.

[7] R. Holzmann, Y. Hervé, R. Demmel: The Maastricht Fiscal Criteria: Required but Ineffective, in: Empirica, Vol. 23, 1996, pp. 25-58.

Single Market in combination with a greater need for pork barrel policy on the part of politicians.

Since the SGP is a voluntary restraint at the national government level, it should be interpreted as the outcome of doubts on the part of national governments that all EMU members will be able to impose tight fiscal rules on themselves. Evidence from US states shows that the enforcement of balanced budget rules is more effective if conducted by outsiders rather than insiders. For example, US states with a constitutional budget constraint which is enforced by an independent popularly elected state supreme court do have a significantly larger budget surplus.[8]

Full Fiscal Coordination versus Coordination Light?

The idea of stepped-up risk sharing in the eurozone, i.e. greater fiscal coordination across countries, derives from the theory of optimum currency areas. Within EMU heterogeneous countries will face country-specific shocks that can no longer be stabilised by the common monetary policy. Since risk sharing through financial markets by holding cross-border financial assets remains negligible in the eurozone,[9] a risk sharing mechanism through coordinated fiscal policy may provide a proper substitute.

The experience of the USA suggests that fiscal sharing between eurozone members might cushion about a good third of the effects on regional employment and consumption triggered by country-specific shocks.[10] Furthermore, Bayoumi and Masson[11] show that federal stabilisation policy in Canada is superior to stabilisation policy applied at the level of the provinces in compensating asymmetric provincial shocks to output.

Measures to establish a eurozone-wide fiscal sharing mechanism would be a European unemployment insurance scheme or a transfers system between national authorities. A uniform negative income tax within the eurozone would even eliminate the need for fiscal sharing between regional authorities. It would, by extension, translate into very close fiscal coordination.

Full coordination, however, might not accommodate national governments' begging to differ on the degree of taxation-related power and the scope of the public sector. Moreover, recent findings on existing large currency areas (Canada, USA) show that the insurance component meant to cushion asymmetric shocks actually merely cancels out some 10% of the relative income loss.[12] Frankel and Rose[13] add to the argument of low effectiveness that a further increase in multilateral trade intensity within the eurozone will eventually result in more highly synchronised regional business cycles and thus reduce the need for full-fledged risk sharing mechanisms.

Besides empirical arguments, Kletzer and von Hagen[14] show that compensatory mechanisms embedded in a dynamic equilibrium model of two regions in a monetary union could, in fact, entail negative welfare effects, since either private consumption or public expenditure would be destabilised depending on the mode of redistribution. This would end in welfare losses. Furthermore, a model with asymmetric regional supply sides also entails repercussions of fiscal sharing on monetary targets. Persson and Tabellini[15] observe that substantial transfers between regions also act as a disincentive to implement measures in favour of supply-side flexibility.

Another theoretical approach to analysing greater fiscal coordination is based on game theoretic models of the Barro-Gordon type.[16] In such models greater fiscal policy coordination within a currency union is clearly advantageous only if the objectives of the central bank correspond to the goals targeted by the national fiscal policymakers.[17] In this case, monetary and fiscal policy measures complement one another

[8] Cf. H. Bohn, R.P. Inman: Balanced-Budget Rules and Public Deficits: Evidence From the U.S. States, in: Carnegie-Rochester Conference Series on Public Policy, Vol. 45, 1996, pp. 13-76.

[9] B.E. Sørensen, O. Yosha: International Risk Sharing and European Monetary Unification, in: Journal of International Economics, Vol. 45, 1998, pp. 211-238.

[10] X. Sala-i-Martin, J. Sachs: Fiscal Federalism and Optimum Currency Areas: Evidence for Europe from the United States, in: M.B. Canzoneri, V. Grilli, P.R. Masson (eds.): Establishing a central bank: Issues in Europe and lessons from the U.S., Cambridge 1992, Cambridge University Press, pp. 195-219.

[11] T. Bayoumi, P.R. Masson: Liability Creating Versus Non-Liability Creating Fiscal Stabilization Policies: Ricardian Equivalence, Fiscal Stabilization, and EMU, in: Economic Journal, Vol. 108, 1998, pp. 1026-1045.

[12] K. Kletzer, J. von Hagen: Monetary Union and Fiscal Federalism, Centre for Economic Policy Research Discussion Paper No. 2615, London 2000.

[13] J.A. Frankel, A.K. Rose: The Endogeneity of the Optimum Currency Area Criteria, in: Economic Journal, Vol. 108, 1998, pp. 1009-1025.

[14] K. Kletzer, J. von Hagen, op. cit.

[15] T. Persson, G. Tabellini: Federal Fiscal Constitutions: Risk Sharing and Moral Hazard, in: Econometrica, Vol. 64, 1996, pp. 623-646.

[16] R.J. Barro, D.B. Gordon: Rules, Discretion, and Reputation in a Model of Monetary Policy, in: Journal of Monetary Economics, Vol. 12, 1983, pp. 101-121.

and their orchestrated combined use has a greater impact on stability for a given level of applied resources.[18] If the objectives of the central bank differ from the national fiscal policymakers' goals, e.g. because the former attaches more importance to price stability, this equation no longer holds. Strategic interaction between fiscal policy and the central bank ensues, exerting upward pressure on prices. In a Stackelberg equilibrium, highly orchestrated fiscal policy even succeeds in crowding out the central bank further, thus further pushing up inflation as well. Beetsma and Bovenberg[19] arrive at similar results. Van Aarle, Engwerda and Plasmans[20] extend the model to a dynamic differential game involving two countries and a central bank with equivalent results to standard Barro-Gordon models.

Conclusions

With full-scale fiscal policy coordination holding obvious disadvantages, the EU Member States, during EMU negotiations, managed to agree on a toned-down version of a rule-based fiscal policy coordination. According to Article 99 of the Treaty of Amsterdam, the Member States shall regard their economic policies as a common concern to be coordinated in such a way that they further well-balanced economic activity within the Community. Drawing on reports by the European Commission, the European Council provides an overall assessment of the national economic policy activities.

The procedure laid down in the Stability and Growth Pact, which was then also incorporated into the Treaty of Amsterdam as well as the Council Regulations (EC) No. 1466/97 and No. 1467/97, calls for forward-looking surveillance of the fiscal policies of all Member States. This kind of supranational surveillance corresponds to a light version of fiscal coordination within the eurozone. The evaluation of Ireland's stability programme of 2001 by the European Council in the light of the then perceived violation of the ECB's inflation target may be instructive for possible benefits from future "coordination light".

The surveillance of national fiscal policies by the European Commission is driven by the commitment to guarantee that each Member State has a budgetary position close to balance or in surplus in the medium term. I argue that the feedback between the weak fiscal discipline of members of a monetary union and the monetary policy of the central bank does not necessitate the surveillance and sanction mechanism established in the Stability and Growth Pact, but rather, the balanced budget rule should be interpreted as a supranational instrument to curb excessive national deficits. In this sense it is comparable to the Gramm-Rudman-Hollings Act and protects future taxpayers from the consequences of weak fiscal discipline.

Possible costs of the rule-based procedure to avoid excessive deficits emerge from restraints on automatic fiscal stabilisers and discretionary stabilisation policy. A recent study by the OECD,[21] however, shows that budget elasticities with respect to the business cycle throughout the eurozone vary between 0.31 (Austria) and 0.76 (Netherlands). Thus the automatic fiscal response to output gaps as large as 3.9 to 9.7 per cent of potential GDP will not trigger the sanction mechanism as long as the initial public sector budget is near balance or in surplus.

During recent months advocates of active Keynesian demand management called for a cancellation of the Stability and Growth Pact in order to widen the leeway for discretionary stabilisation policy over the anticipated downturn in 2001 and 2002. This unexpected revival of fiscal activism ignores all previous doubts about the recognition, decision and implementation lags of fiscal policy which eventually turn discretionary spending procyclical. Moreover, from the perspective of a small open economy within the eurozone negative external effects from the violation of deficit ceilings by large eurozone members easily outweigh any advantage from higher degrees of freedom in the setting of national fiscal policy. Thus, lifting the Stability and Growth Pact would not only deprive European citizens of an external surveillance system for profligate national governments but also abolish an economically sensible coordination mechanism for fiscal policy within the eurozone.

---

[17] A. Dixit, L. Lambertini: Monetary-Fiscal Policy Interactions and Commitment Versus Discretion in a Monetary Union, in: European Economic Review, Vol. 45, 2001, pp. 977-987.

[18] G. Tichy: Austro-Keynesianism - Psychology-Supported Business Cycle-Policy, in: Human Systems Management, Vol. 5, 1985, pp. 66-73.

[19] R.M. Beetsma, A.L. Bovenberg: Monetary Union Without Fiscal Coordination may Discipline Policymakers, in: Journal of International Economics, Vol. 45, 1998, pp. 239-258; R.M. Beetsma, A.L. Bovenberg: The Optimality of a Monetary Union Without a Fiscal Union, in: Journal of Money, Credit, and Banking, Vol. 33, 2001, pp. 179-204.

[20] B. van Aarle, J. Engwerda, J. Plasmans: Monetary and Fiscal Policy Interaction in the EMU: A Dynamic Game Approach, CESifo Working Paper No. 437, Munich 2001.

[21] P. van den Noord: The Size and Role of Automatic Fiscal Stabilizers in the 1990s and Beyond, OECD Working Paper No. 230, Paris 2000.

Friedrich L. Sell*

The European Stability Pact under Scrutiny

The eurozone may be on the brink of a full-blown recession. Most growth forecasts for 2001 and 2002 have been lowered substantially in recent weeks, and some of them predict that economic activity could well stagnate, or even contract, in the final quarter of this year. The stabilisation role of demand and supply policies and the proper policy mix in general is going to be a hot issue in the European public debate in the coming months. The European stability pact is under particular scrutiny. Not for the first time since 1997, when it was concluded at the Amsterdam conference, serious doubts have been raised about its meaningfulness in times of an approaching recession. In part, the arguments presented in favour of a "relaxation" seem to overlook the various exemptions and/or flexible contents of the pact. Opponents of a relaxation, on the other hand, seem to overstress credibility aspects and the overall harmful effects on European monetary union and to neglect the credibility of the policymakers vs. credibility of policies perspective. The deficit criterion of the stability pact is not only binding for EMU members, but it is also among the Maastricht criteria to be applied to EMU candidates. As we intend to show, it may make (even) less sense here to apply pressure at the wrong time and in the wrong place.

Full Interpretation vis-à-vis Relaxation

First of all, we should take a careful look at the "Key Provisions of the European Council Resolution on the Stability and Growth Pact" (Appendix A and B) of the Amsterdam conference in 1997. There, it is stated[1] that the Member States commit themselves to respect the medium-term budgetary objective of positions close to balance or in surplus set out in their stability or convergence programmes. The Member States promise that they will correct excessive deficits as quickly as possible after their emergence. This correction should be completed in the year following its identification, unless there are special circumstances and they commit themselves not to invoke the benefit of Article 2 paragraph 3 of the Council Regulation on speeding up and clarifying the excessive deficit procedure unless they are in a severe recession. In evaluating whether the economic downturn is severe, the Member States will, as a rule, take as a reference point an annual fall in real GDP of at least 0.75%.

The Commission commits itself to prepare a report under Article 104c(3) of the Maastricht Treaty whenever there is the risk of an excessive deficit or whenever the planned or actual government deficit exceeds the 3% of GDP reference value, thereby triggering the procedure under Article 104c(3). The Commission commits itself, in the event that it considers that a deficit exceeding 3% is not excessive and this opinion differs from that of the Economic and Financial Committee, to present in writing to the Council (ECOFIN) the reasons for its position. It commits itself, following a request from the Council under Article 109d, to make, as a rule, a recommendation for a Council decision on whether an excessive deficit exists under Article 104c(6). The Council is invited to impose sanctions if a participating Member State fails to take the necessary steps to bring the excessive deficit situation to an end as recommended by the Council. The Council is urged to always require a non-interest bearing deposit, whenever it decides to impose sanctions on a participating Member State in accordance with Article 104c(11).

The Council is urged always to convert a deposit into a fine after two years, unless the excessive deficit has in the view of the Council been corrected; the excess of a government deficit over the 3% reference value shall be considered exceptional and temporary when resulting from an unusual event outside the

* Professor of Economics, University of the Federal Armed Forces, Munich, Germany.

[1] See, for the following, C. Köhler: Vertragliche Grundlagen der Europäischen Währungsunion. Volkwirtschaftlicher Kurzkommentar, Berlin 1999, pp. 129-190; and F. L. Sell: Zu den Wirkungen des Stabilitätspaktes in der Europäischen Währungsunion, in: IFO-Studien, Vol. 44, No. 3, 1998, pp. 233-266, in particular pp. 262-266.

control of the Member State concerned and which has a major impact on the financial position of the general government, or when resulting from a severe economic downturn. In addition, the excess over the reference value shall be considered temporary if budgetary forecasts as provided by the Commission indicate that the deficit will fall below the reference value following the end of the unusual event or the severe economic downturn.

When preparing a report under Article 104c(3) the Commission shall, as a rule, consider an excess over the reference value resulting from an economic downturn to be exceptional only if there is an annual fall in real GDP of at least 2%. The Council, when deciding whether an excessive deficit exists according to Article 104c(6), shall in its overall assessment take into account any observations made by the Member State showing that an annual fall in real GDP of less than 2% is nevertheless exceptional in the light of further supporting evidence, in particular on the abruptness of the downturn or on the accumulated loss of output relative to past trends.

The relevant passage for the current discussion is definitely the first paragraph which makes reference to the so-called stability (for three countries: convergence) programmes.[2] In essence, countries commit themselves here to achieving balanced public budgets or surpluses in the medium run, which might help those countries in particular which entered EMU with the burden of large public debt quotas. Strictly speaking, the possible violation of this self-commitment does not lead to any explicit sanction either in the form of a forced non-interest bearing deposit or in the form of a fine.[3] The relevant cost could therefore only consist in the possible loss of reputation of the respective national fiscal authority. But, as we intend to show in the following, this outcome is not very likely and the implied reasoning is based on a confusion between the credibility of policy on the one hand and the credibility of policymakers on the other hand.

Besides this, the regulations of the stability pact imply that a government has a variety of exemption clauses (see above) on which it can draw. If these exemption clauses do not apply, both the Council and the Commission, separately, also have to take several discretionary decisions.[4] Only if all of them receive the necessary majority and run against the government concerned, does the jurisdiction of the stability pact become effective. Existing prognoses for the coming year do attach a certain likelihood to such a scenario (deficit quotas exceeding the permitted 3%) for two or three countries.

A Closer Inspection of the Credibility Argument

A number of economists claim that a relaxation of the stability pact would damage the credibility of the European monetary union and its institutions. They take it as given that a violation of the pact's provisions would not only invalidate the non-bail-out clause, but could also force the ECB to a looser monetary policy in order to "compensate" for the raised long-term interest rates with lower short-term interest rates. Both arguments may or may not be true, but they are irrelevant – for the moment, at least. This is because the current situation of EU members neither points to a fall in their GDP of 0.75%, let alone 2%, nor are deficit quotas which exceed the critical 3% expected – if we disregard possible exemptions. So is there much ado about nothing?

The credibility of European monetary union hinges very much upon the credibility of Europe's fiscal policy and less upon the credibility of European policymakers. A policymaker may be completely right when reneging on his commitment if circumstances are bad enough. This point was made by Alan Drazen and Paul Masson about seven years ago and it has, it seems to me, not yet reached enough members of the scientific community, let alone European journalists and politicians. "If tough policies constrain the room to manoeuvre in the future, the following of a tough policy may actually harm rather than enhance credibility"[5] by constraining the choices of future policymakers. The credibility of European monetary union does not monotonically increase with the length of time there has been a full meeting of the yearly targets announced by policymakers within their national stability programmes, to speak in the words of Drazen and Masson.[6] On the contrary, given the unbroken relevance of the business cycle, such an outcome may under certain circumstances point to a pro-cyclical behaviour of fiscal policy which would tend to endanger the ambitious long-term goals of the

[2] For an overview of the programmes see ECB: Monthly Bulletin, March 2001, p. 43.

[3] F. L. Sell, op. cit., pp. 265-266.

[4] ECB: Monthly Bulletin, May 1999, pp. 54-59.

[5] A. Drazen, P. Masson: Credibility of Policies Versus Credibility of Policymakers, in: Quarterly Journal of Economics, Vol. 109, No. 3, 1994, pp. 735-754.

[6] Ibid., p. 737.

stability pact and dismantle the credibility of fiscal policy.

For the reputation of a fiscal policy which is compatible with the medium to long-term debt/deficit goals of the Commission, it is not decisive that the targets of the stability programmes are fulfilled in every single year. On the contrary, only the intertemporal consistency of the stability programme is significant. This type of reasoning has a corollary in the policy followed by the Deutsche Bundesbank until the end of 1998: "In the case of Europe, the Deutsche Bundesbank ... can serve as a good example of the type of monetary authority ... that we visualise. In contrast to the traditional view of reputation, we believe agents to have confidence in central banks as long as reneging/cheating – when it happens – is regarded only as a transitory phenomenon which does not endanger price stability".[7]

In other words, European finance ministers should have been more courageous in recent years when the expansionary economic development would have allowed for a more rigorous reduction in public deficits. The annual deficit goals of the national stability programmes of the respective fiscal authorities were too loose in good times, and now they may become too strict for hard times.[8] There is no reason, however, for a generalised disillusion concerning the performance of the stability programmes: in 1999, of the 15 EU member countries just one country met its target quota (and in 2000 two countries), only 1 country exceeded its target deficit quota (none in 2000), but 13 countries did better than previously announced.

The Stability Pact Embedded in the Maastricht Criteria

As is widely known, Article 121 (previously: 109j) in conjunction with Article 104, paragraph 6 and the Protocol to Article 109j of the EU contract define the so-called Maastricht criteria which should be met by any candidate for membership in EMU. Among them is the requirement to "achieve" public deficit quotas well below the critical level of 3% and public debt quotas below 60%. Both of these criteria are questionable from a sound economic development point of view with regard to the applicant emerging economies in central and eastern Europe. Why? These countries have a considerable backwardness vis-à-vis the EMU countries as far as their per capita income and their physical infrastructure is concerned. A major goal of their economic policy – surrounded by a world-wide "systems competition" – should be to attract as much private mobile capital from abroad as possible, i.e. as much as they can afford without putting their domestic financial sector under stress and avoiding speculative attacks against their currencies.[9] This aim can be attained all the more easily and quickly if the government is allowed to exceed critical deficit and debt quotas for a certain length of time.

If public deficits are motivated by investment expenditures, a concomitant rise in the public deficit and in the public debt quota beyond the Maastricht levels is legitimate from an economic point of view. What if these countries do qualify "too early", so to speak, for EMU? They will then find themselves locked in a dilemma: on the one hand they should actively pursue the strategy explained above, but on the other hand their hands are, once members of EMU, tied to the restrictions of the stability pact.

Conclusions

The philosophy of the stability pact has always been to reduce the structural components of the public deficit.[10] If successful, this strategy should enable national governments to achieve balanced budgets in the medium run during "normal times" and surpluses during an economic upswing. It was never meant that deficits incurred by economic downswings, let alone recessions, had to be avoided or minimised. And yet, the performance of the EU 15 countries with their stability programmes during 1999 and 2000 has not been too unsatisfactory. However, a year-by-year evaluation of promises made by national ministers of finance within their stability programmes cannot be the (only) clue to the credibility of fiscal policy in EMU. Moreover, during a recession, such a strict policy could steer countries directly into a violation of the explicit rules of the stability pact. The damage to be expected in terms of reputation lost would be indisputable. The deficit criterion is more than questionable in the case of emerging economies which may become candidates for EMU "too soon" and lag behind in their per capita income.

---

[7] Quote from H. Maass, F. L. Sell: Confident Expectations, Rational Expectations and the Optimal Conduct of Monetary Policy, in: Economic Modelling, Vol. 15, No. 4, 1998, pp. 519-541, here p. 520.

[8] For a similar view see ECB: Monthly Bulletin, March 2001, pp. 42-45.

[9] A recent study on contagious speculative attacks is provided by F. L. Sell: Contagion in Financial Markets, Cheltenham (UK) and Northhampton, Mass. (USA) 2001, Edward Elgar.

[10] See R. Peffekoven: Der Abschwung erlaubt höhere Defizite, in: Handelsblatt, No. 205, 24.10.01, p. 10.