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The stability and growth pact: How much co-ordination?

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The Economic and Social Research Institute

The *Stability and Growth Pact*: How Much Co-ordination?

by

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Working Paper 133



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Introduction

Relying on legislation rather than electorates to keep governments wise is not a recipe for long-term success. Gramm-Rudman in the United States did not prevent governments running huge deficits and the Euro zone's *Stability and Growth Pact* (SGP) is looking increasingly likely to become a casualty of a recession crossed with political pressures. The requirement that fiscal policy be put on a sound footing for membership of monetary union, when tied to the credible threat of exclusion for non-compliance, was successful in the 1990s. However, today, without the presence of credible penalties or sound intellectual reasons for compliance, the SGP has lost its teeth. Under these circumstances it comes as no surprise that the President of the EU Commission is unhappy left trying to enforce a set of rules that do not have a clear logic. It is damaging the Commission's credibility, without any prospective pay-off in terms of improved future economic performance.

While EMU was seen as having broadly favourable economic consequences by its founder members, the creation of the EMU changed the operating environment for all member economies by creating new channels through which the actions of individual members states could adversely affect the citizens of other members. It is this possibility of negative externalities for the union from fiscal policy in individual members (or a group of members) that required the addition of new rules for coordinating fiscal policy, leading to the agreement on the SGP. This need for additional co-ordination only applies to the members of the EMU; Denmark, Sweden and the UK as non-members lack the same potential to cause collateral damage to members of the EMU through imprudent domestic fiscal policy.

Need for Co-ordination Under EMU

There are three main channels through which economic policy in regional economies of the EMU can potentially cause collateral damage to other members:

- Problems with the security of the banking system in one region could potentially affect all member states.
- In spite of the no bail-out agreement, potential debt default in one regional economy could add to the risk premium payable by all other member governments, seriously raising the cost of capital.
- Inappropriate stimulation by fiscal policy in a region¹ (or regions) of the EMU, by adding to inflationary pressures, could cause the ECB to raise interest rates, penalising those economies that had pursued sensible policies.

The SGP does not address the first of these possibilities, targeting instead the last two through its commitment to budgetary balance over the cycle and a limit on borrowing of 3% of GDP. Two questions must be asked about the SGP:

- Is it effective in tackling the increased dangers from unwise fiscal policy action that arise from the creation of the monetary union?

¹ Here individual national members are considered as regions of the EMU.

- Does it respect the principle of subsidiarity in requiring no more co-ordination of fiscal policy than is necessary to tackle these two dangers?

Financial Stability

All the members of the euro area have a clear interest in the stability of regional financial systems within the zone. Instability in one region could easily translate into a problem for all members. However, the supervision of the regional financial systems remains a national prerogative.

With the integration of the EU economy there may be a need to extend co-ordination of policy in this area. Certainly the creation of a monetary union enhances the risk that a regional financial collapse could have ramifications throughout the monetary union. The example of the BCCI débacle in the UK shows the difficulties in supervising banking systems in a global environment. Globalisation may require further co-ordination of banking supervision to ensure that problems in multinational financial enterprises do not go undetected.

It is not clear how far the ECB would feel required to intervene in the case of a regional financial collapse, such as occurred in Scandinavia in the late 1980s. Within a monetary union the scope for action by the national central banks is curtailed. This leaves uncertainty as to the assignment of responsibility, which could lead to difficulties, especially if a regional financial collapse was initially felt not to endanger the financial system of the union as a whole. The SGP does not deal with this potential problem.

Danger of Default

The current SGP involves rules covering both the debt-GDP ratio and borrowing as a percentage of GDP. However, if the only concern were the possibility of a government becoming insolvent, then the borrowing criterion is redundant. Pisani-Ferry, 2002, argues that if solvency were the only concern, the rules of the SGP should be amended so that if a country's debt-GDP ratio were below a certain specified level (e.g. 60%), a country should not be required to maintain a balanced budget over the cycle.² However, because it is written into the treaty, the 3% limit on borrowing would still apply for legal reasons, even if not for economic reasons.

Such a rule would certainly protect members of the EMU from the danger of any individual country becoming insolvent. It would also meet the subsidiarity criterion by allowing individual countries that meet the debt criterion considerable scope to choose their own fiscal policy stance. However, it would not deal with the danger that an inflationary fiscal policy pursued by one or a number of members of the union would impact unfavourably on other member states pursuing a non-inflationary policy.

This proposal still leaves a problem in choosing the appropriate debt-GDP ratio below which countries would be free to choose. The appropriate debt-GDP ratio for individual countries is likely to show considerable variation and a "one size fits all policy", while having the attraction of being simple, is unlikely to be optimal from the point of view of maximising the

² He also suggests a requirement to maintain stricter accounting standards to ensure transparency.

utility of individual countries, or of the union as a whole. There is already considerable variation in the demographic profiles of the member states of the union, and the prospect of enlargement, with many additional countries eventually joining the EMU, makes the adoption of a single rule on the appropriate debt-GDP ratio sub-optimal. In particular, where countries have a major deficit in public infrastructure, or where the demographic profile is particularly favourable, it is possible that higher levels of borrowing may be optimal.

In Germany, France, and Italy in the 1960s and the 1970s the investment to GDP ratio was close to 25% whereas today it is around 20%. This is reflected in the fact that public investment in infrastructure was also significantly higher than today. If these countries had been constrained from borrowing to fund infrastructural investment in the 1960s and the 1970s it could well have adversely affected their long-term growth potential. In the case of the current cohesion countries in the EU, investment rates are running significantly higher than in the other EU members. This reflects the infrastructural deficits that exist in these countries. A severe constraint on public borrowing in these countries, and in the new accession countries, could also slow their rate of convergence in living standards.

The restriction on borrowing also has implications for intergenerational equity. It means that the current generation in the cohesion or accession countries must carry, through current taxation, all the cost of putting in place infrastructure that will benefit future generations. While this may be appropriate where the demographic profile is unfavourable, it will not always be true. In the past, in Europe, significant borrowing was undertaken to put in place the infrastructure in those countries that are currently the most wealthy.

This concern that necessary public sector investment in infrastructure should not be constrained by too tight a limit on borrowing underlies the UK government's "golden rule": borrowing should only be undertaken to fund capital investment. However, experience elsewhere (Ireland in the 1970s and Japan in the 1990s) indicates that such a rule is open to abuse through inappropriate classification of public expenditure to get round the constraint on borrowing. It also takes no account of depreciation of the existing stock of public infrastructure.

In a recent paper, Blanchard and Giavazzi, 2002, propose that instead of a golden rule, countries should be allowed to borrow to fund net public investment (net of depreciation) and they propose institutional safeguards that might provide some protection against abuse. This variant of the "golden rule" is more logical from an economic point of view in that the cost of capital consumption (depreciation) is a charge on current taxation. However, like the "golden rule" it would not constrain countries from undertaking necessary and desirable infrastructural investment. If such a rule were followed, in the long run public sector debt would equal the stock of public infrastructure.

Any such rules would probably also have to include an upper bound on the debt-GDP ratio to ensure that the union is protected from the dangers of an individual country becoming insolvent. Such insolvency could occur if, for example, there was over-investment in unproductive infrastructure. It would also have to include the 3% deficit rule unless and until such a rule was removed through an amendment to the treaty establishing the EMU. The removal of the 3% limit, while desirable, might be difficult to achieve, possibly involving a further referendum in certain member states.

Danger of Inflation

In co-ordinating the overall stance of fiscal policy in a national economy in a monetary union it is not necessary, or appropriate, to specify the mix of taxation and expenditure to be pursued in individual countries. What is important is the overall fiscal stance – the change in the cyclically adjusted deficit or surplus.³ (The latest Commission proposals recognise this, though identification of the cyclical element in deficits may be part art and part science.) It is this change in government saving that represents the ultimate impact on demand in the euro area. Even if individual countries are to be constrained to follow a particular path in terms of the change in their government savings (deficit), they still have autonomy in determining what mix of expenditure and taxation they will use.

If fiscal policy at the level of the euro area is appropriate (not putting pressure on interest rates through creating inflationary pressures), then independent action by an individual regional economy does not adversely affect other members. However, if a fiscal stimulus in one country contributes to an inappropriate fiscal stance at the level of the euro area, there is the possibility that it will require a tightening of monetary policy, with negative consequences for all other EMU members. This potential negative externality is the second important reason for co-ordination of fiscal policies (Butti and Martinot, 2000). Outside the euro area this need for co-ordination would not arise because changes in demand in a country outside EMU would not have any significant direct effect on interest rates in the euro area.⁴

The example of German unification highlights the possible gains to be obtained from effective fiscal policy co-ordination at the level of the euro area. In 1990 the huge infrastructural deficit that existed in the Eastern Länder of the newly unified Germany posed major problems for its government. However, a decision was made that taxes would not be raised to cover the full costs of unification, and government borrowing grew rapidly. This provided a very strong demand stimulus to the German economy. This stimulus was further accentuated by the decision to convert East German savings into deutschmarks at par. The consequence of the stimulatory fiscal policy pursued in Germany was that the Bundesbank had to tighten German monetary policy to offset the inflationary impact of the demand stimulus. However, the rise in interest rates in Germany was transmitted to all the other members of the ERM. Given the nature of the ERM this meant that there were serious negative externalities for the rest of the EU from procyclical German fiscal policy (Gagnon, Masson and McKibbin, 1996 and Barrell, Pain and Hurst, 1996).

If EMU had begun in 1990, with effective co-ordination of fiscal policy, it is likely that fiscal policy in Germany would have been much tighter than was actually the case in the early 1990s. The result would have been that the EU would have escaped the major rise in interest

³ While a stimulus can also be given by a balanced increase in expenditure and revenue the impact of such a stimulus (the balanced budget multiplier) will be small relative to a change in expenditure funded by borrowing.

⁴ Co-ordinated fiscal policy action does not entail a harmonisation of tax or welfare rates across regional economies. A harmonisation of prices (including taxes and welfare rates) would prevent the normal adjustment processes necessary to promote convergence. Such differences are essential to ensure optimal use of resources within the euro area. However, there may be cases where discriminatory fiscal action may adversely affect other EU members but this will not be confined just to members of the euro area. It is also not an issue for the short-term management of the euro area economy and, as a result, it is not an issue to be considered in the guidelines for fiscal policy.

rates that actually occurred. Gagnon, Masson and McKibbin (1996) and Barrell, Pain and Hurst (1996), estimate that the cost of inappropriate fiscal policy in Germany in the early 1990s was a loss in GDP of 2 to 3 percentage points in the UK, France and other EU members (other than Germany). While the increased demand from Germany resulted in increased exports from other EU members, this beneficial effect was more than offset by the negative effects of higher interest rates.

This is a very clear example where co-ordination of fiscal policy could have been beneficial to the members of the EMS as a whole (as well as probably saving the German economy from some of its current difficulties). If there had been a monetary union in 1990 Germany would have had to take into account the wider impact of its fiscal policy stance. In turn this would have required higher taxation or lower current expenditure in Germany to pay for unification, but the consequence would have been much lower interest rates and higher growth elsewhere in the monetary union.

Figure 1: Effect of German Stimulus on Interest Rates

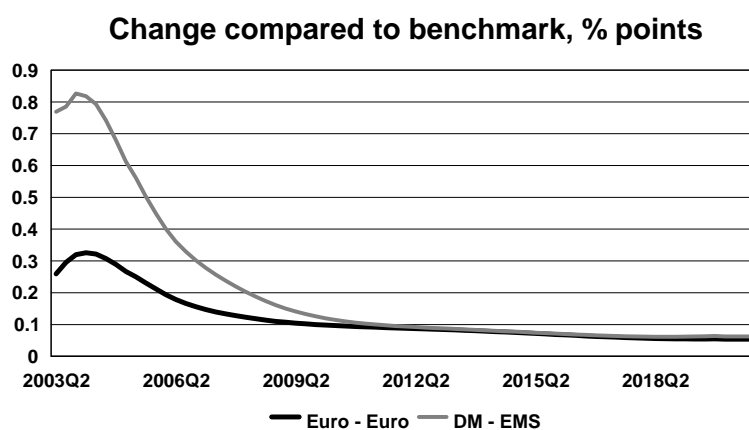
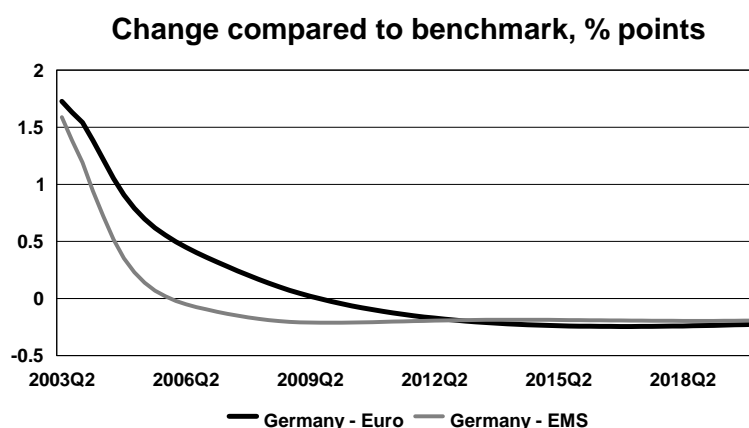


Figure 2: Effect of German Stimulus on German GDP

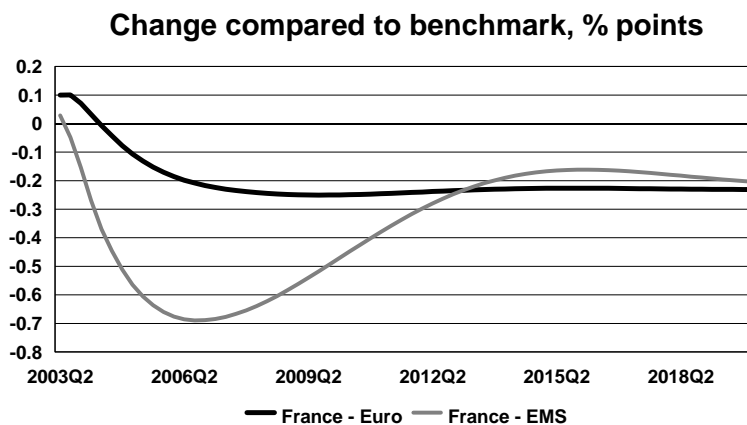


For the future, disruptive fiscal policy action in large members of EMU, or disruptive action by a combination of smaller members of EMU, could potentially impose significant economic costs on all member states. Under these circumstances it remains desirable that the EU Commission has the power to co-ordinate fiscal policy within the euro area. However, it is an empirical question whether this potential danger of inflationary pressures arising from

inappropriate fiscal policy action in any one member state (or a combination of member states) is likely to occur.

A study by Gros and Hobza, 2001, using the EU model QUEST and the UK National Institute model NiGEM suggests that the dangers of such inflationary shocks from inappropriate fiscal policy are much less likely under EMU than under the old EMS. This is because the effects from a fiscal stimulus in one country on the Euro area inflation will be much smaller than on the inflation rate of the country undertaking the stimulus. Because the ECB targets the Euro area inflation rate, and is not charged with responsibility for regional inflation rates, its response would be very limited.

Figure 3: Effect of German Stimulus on French GDP



In considering the dangers from fiscal spillovers under EMU we use the latest version of the NIESR NiGEM model to consider how a fiscal stimulus in one regional economy of the EMU can impact on other members of the EMU. In this example we look at the wider effects of a fiscal stimulus in Germany under different monetary regimes. We consider the case of the current EMU regime and also the case of the EMS regime of the 1990s, where interest rates in the other EMS countries tended to track DM rates. We look at the effects of a sustained rise in current government consumption in Germany of around 2% of GDP in 2003. This rise in expenditure is assumed to be funded by borrowing.

Under the old EMS regime the effect of this stimulus would have been to raise the German rate of inflation, resulting in the price level peaking at over 0.6% above its base level. Using a standard reaction function, the Bundesbank would have raised interest rates, peaking at 0.8 percentage points above the baseline (Figure 1). Under the EMS regime, the rise in interest rates in France would have been of a similar order of magnitude.

Under EMU the effect of the stimulus would be to raise the Euro area rate of inflation to a peak of 0.3% above the base. As the ECB targets the Euro area rate of inflation, this would result in a rise in a rise in Euro interest rates, peaking at 0.3% above base, well below what would have happened under the EMS regime (Figure 1). The result of this more “relaxed” monetary regime would be that the price level would peak in Germany at 1.2 percentage points above the base, significantly higher than would have been the case under the EMS.

The effects of the different regimes on GDP in Germany are shown in Figure 2. This shows a rather similar profile for the short-term impact on output. However, the Euro regime would

see a somewhat slower fall-off in the positive impact on demand, reflecting the more “relaxed” monetary regime.

The major difference between the two regimes would occur in the case of France and, by implication, the other members of EMU. Under the EMS interest rates there would have risen by much more than would be the case under EMU. The result would have been that GDP would have fallen to a minimum of 0.7% below base under the EMS. Instead under EMU GDP would fall to a maximum of 0.25% below base.

What these simulations show is that the potential for unwise fiscal policy in Germany to damage the rest of the EMU is much reduced under EMU compared to the EMS regime of the 1990s. In fact the damage done to neighbouring countries is likely to be quite small under EMU because the ECB targets the Euro inflation rate and because a fiscal stimulus in one regional economy, albeit a very large region such as Germany, can not have a major impact on the Euro area inflation rate. This suggests that the current concern with implementing co-ordination of fiscal policy, through the SGP, to protect the EMU from unwise action by any member economy is unnecessary.

In a separate set of simulations we considered the likely impact of a fiscal stimulus in Germany under an alternative regime where each member state pursued an independent monetary policy. The results of these simulations suggested that the negative impact on other countries currently members of EMU would not have been very different from what it would be under EMU. In other words the potential for one member state to damage another through unwise fiscal policy is *de facto*, not greatly enhanced by the advent of EMU.

While in each case the impact of a fiscal stimulus in Germany has been considered on the French economy, the results for the other members of EMU would be broadly similar. It is also the case that the effect of a stimulus of a similar magnitude in any other country would have similar effects on the Euro area economy. This suggests two conclusions:

- Under EMU, unwise fiscal policy in one regional economy, including that of Germany, has very limited scope to damage the economy of the Euro area as a whole.
- This contrasts with the situation under the EMS where unwise fiscal policy in Germany could damage the economies of other EMS members.

Compared to a situation where each country acted independently, the advent of EMU has not greatly increased the exposure of members of EMU to unwise fiscal policy by any other member.

These conclusions suggest that the SGP should be seen as the child of the EMS regime. Under that regime participants would have been significantly better off with such a set of fiscal rules along the lines of the SGP. However, the potential benefits from enforcing the SGP under EMU are much smaller. The potential gains to be obtained from a rigid application of the SGP do not look to be worth the political capital that has been invested in trying to enforce them.

Obviously there may be exceptional cases where the adverse impact of unwise fiscal policy could be enhanced – where there are non-linearities not captured in the NiGEM model. However, these simulations suggest that over the next decade such events may be few and far between. If these results proved to be robust, they suggest that the concerns about an

inappropriate inflationary fiscal policy in an individual Euro area member (or even group of members) causing a substantial rise in interest rates are exaggerated. It would require a very big shock across more than one large member state before such a rise would be realised. The implication of this research is that the SGP is probably too concerned with the issue of the short-term fiscal stance of member states of the EMU.

Domestic Fiscal Policy

Whether or not the Stability and Growth Pact is to be reformed, it can be argued that by focusing undue attention on itself, it is distracting attention from consideration of the best economic approach to the difficulties of many Euro area economies. An extensive economic literature has developed considering fiscal adjustments around the world over the last thirty years. Alesina and Perotti (1995) after reviewing the available literature, including the evidence from Ireland in the 1980s, drew conclusions as to the best approach to dealing with such problems. They concluded that when countries get into fiscal difficulties, urgent action, involving significant cuts in public expenditure, offers the best prospect of a return to growth. While tough action would undoubtedly deflate the relevant economy in the year it took place, the damage might be much less than would result from a fiscal war of attrition. The Irish experience of the 1980s would tend to confirm this; so too would the dramatic turnaround in the Finnish economy in the early 1990s, following on an immediate and strong fiscal response to major shocks that hit that economy in 1989-1990.

Eichengreen, 1998, emphasises that the effects of a fiscal tightening will depend very much on the context in which the tightening takes place. In the current Euro area context fiscal attrition leaves consumers and investors uncertain about the future, resulting in depressed consumption and investment levels. While a short sharp shock will undoubtedly depress demand even more in the year it takes place, it holds out the prospect that from that point onwards things will continuously get better. Once consumers and investors respond, the public finances improve further and unemployment would begin to fall. Ireland experienced such a “virtuous circle” in the 1990s after a decade of wasted opportunities.

In the light of this literature it might be in the best interests of some key Euro area governments if they took urgent action to reduce their fiscal imbalances through cutting expenditure. The desirability of this course has nothing to do with the SGP, but stems rather from the depressing effect on private sector expectations of the continuing focus on fiscal problems and the continuing ineffectiveness of governments in dealing with them. As in the Irish case in the 1980s, such a course of action could also mobilise a sense of urgency to deal with the wider problems affecting competitiveness in these economies as part of the Lisbon Agenda. While the short-term cost, both economic and political, could be significant, it would probably hold out the best prospect for a rapid return to future growth. The effect of the debate on the SGP is to distract from the real issues for fiscal policy in individual countries and to promote the belief among consumers and investors that prospects are truly gloomy.

Conclusions

The SGP as it stands is not firmly grounded in economic logic, making it an ineffective instrument for achieving the necessary co-ordination of fiscal policy within the Euro area. However, it is probably not the best time to change it radically, just when it is coming under political pressure due to unwise fiscal policies pursued in a number of member states. Change

might be better undertaken once the current problems are resolved, ensuring that the credibility of having wiser rules in the future is not fatally damaged by a clear lack of political commitment. In the medium term it seems sensible to seek a reform of the SGP within the existing treaties, even if this means that some unsatisfactory provisions of the SGP are left in place.

The reforms should respect the principle of subsidiarity: the regulations should leave maximum powers to individual countries in the field of fiscal policy, subject to the need to ensure that unwise action by individual countries does not harm the interests of the EMU.

As a measure of fiscal stance it seems preferable on economic grounds to use the cyclically adjusted deficit rather than the actual deficit. However, the difficulties in defining such a deficit may pose practical problems in implementation.

To prevent national governments becoming insolvent it is necessary to have a restriction on the level of debt relative to GDP. Pisani-Ferry suggests, if the debt-GDP ratio for an individual country lies above the specified threshold (e.g. 60%) then it is necessary to have a borrowing rule to ensure that the country follows a sustainable path for fiscal policy bringing it within that threshold. The mechanics of such a rule are teased out in Gros, 2003. Below the predetermined threshold supervision by the Commission is not necessary. The Blanchard-Giavazzi rule (a modified version of the UK "Golden Rule") allowing borrowing to fund net investment in public infrastructure seems a sensible rule for governments to follow in any event, and it would ensure that in the very long run the public debt was equal to the stock of public infrastructure. Unless there is a change in the Treaties this borrowing would still have to be less than 3% of GDP.

Co-ordination of fiscal policies to avoid inflationary pressure arising from a fiscal stimulus is probably less important than is commonly supposed. The occasions when action will be necessary to achieve such co-ordination will probably arise infrequently in the future. At no time since EMU began has this been a problem. While the fiscal policies of a number of members states are likely to breach the requirements of the SGP again this year, there is no suggestion that these policies are currently causing inflationary pressures within the EMU. For the future, where inflationary pressures are present due to the combined fiscal stance of the EMU, it is might still be desirable to reserve the power to the Commission to require the member states pursuing the most stimulatory fiscal policy to mend their ways.

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