Should the Stability and Growth Pact be reformed?

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Briefing paper for the Committee on Economic and Monetary Affairs of the European Parliament

5 February 2004

1. The rationale of fiscal policy rules in a monetary union

For an assessment of the SGP and a discussion of its reform it is necessary to define shortly the rationale of fiscal policy rules in monetary union. It is widely agreed that the main reason for such rules derives from the specific situation of EMU where a single monetary policy player at the European level is confronted with a multitude of fiscal policy players at the national level. There are three areas where fiscal policy rules are useful.

First, there is no guarantee that the independent actions of 12 national governments lead to an aggregate policy stance that is adequate to the overall macroeconomic situation in the euro area. Above all, smaller countries might be tempted to avoid their contribution to a necessary macroeconomic stabilisation. This externality could prevent an adequate fiscal policy response of the euro area in the case of demand shocks.

Second, overly expansionary national fiscal policies could lead to inflationary pressure in parts of the euro area. In contrast to a nation state with an autonomous national central bank, the ECB is not able to retaliate such an individual policy directly, especially if it is caused by a relatively small country.

Third, under the umbrella of a single currency, an individual country could pursue an unsustainable fiscal policy since there is no longer the threat of a depreciation of its currency. In addition the sanction exerted by financial markets could be too weak or it could come too late since market participants might expect a "bail-out" by other EMU members or by the ECB.

In this paper I will discuss these issues and show how the SGP has performed so far in providing the required guidance for national fiscal policies.

2. Simple rules in fiscal policy and in monetary policy

Given these rather complex tasks it is surprising that the SGP relies on a very simple rule for fiscal policy:

"Adherence to the objective of sound budgetary positions close to balance or in surplus will allow all Member States to deal with normal cyclical fluctuations while keeping the government deficit within the 3 percent of GDP reference value."

While this simple rule leaves some leeway to countries with "sound budgetary positions", it completely removes the discretion for policy makers in countries that have not yet reached this state.[1] It is important to note that the rigidity which the SGP has created for national fiscal policies in some countries stands in a stark contrast to the flexibility that the ECB requires for the common monetary policy. E.g. the ECB is strongly opposed to Taylor rules and to a mechanic observance of monetary rules:

„Under certain circumstances, simple unconditional rules – like an unfettered gold standard or a constant money growth rule – may lead to undesirably high volatility in prices and output. As a consequence, such rules have not, in practice, been applied in their strict form." (ECB 2001, p. 39):

As a consequence, in the last few years the ECB had allowed a strong and persistent deviation of the growth rate of the money stock M3 from to its own reference value of 4.5 % which it still regards as a benchmark for its stability-oriented monetary policy. The ECB is not even willing to adopt the very weak form of rule that is provided by the strategy of inflation targeting. In a paper on the review of its strategy the ECB (2003, p. 17) writes:

„In this respect, the argument can be made that a strong focus on a single inflation forecast would not do justice to the complexity of the decision-making process and would also not provide a transparent means to communicate this complexity."

3. Co-ordination of the aggregate fiscal policy stance in euro area

Michel Artis (2002, p. 115) argued that the SGP "must rank as one of the most remarkable pieces of policy coordination in world history. Its construction makes it in some respects comparable to the founding of the Bretton Woods system." However, macroeconomic policy coordination was not a central concern of the founding fathers of the SGP. Instead they wanted to develop an institution that was suited to calm down the inflation fears of the German public. At the Amsterdam Council the SGP was explicitly declared "as a means to strengthening the conditions for price stability".[2] With this one-dimensional focus on price stability the equally important aim of macroeconomic policy coordination in the new environment of a monetary union was completely disregarded. The result of this neglect becomes obvious if one compares the macroeconomic performance of the euro area and the United States since 1999.

As Chart 1 shows the two currency areas started in 1999 and 2000 with healthy growth rates. In 2001 they were both affected by a major oil price shock, a crash in stock markets and by the political instability that followed September 11. But since 2002 a remarkable bifurcation has taken place. While the United States could return to a strong growth path, the euro area suffered from an unexpected economic deceleration.

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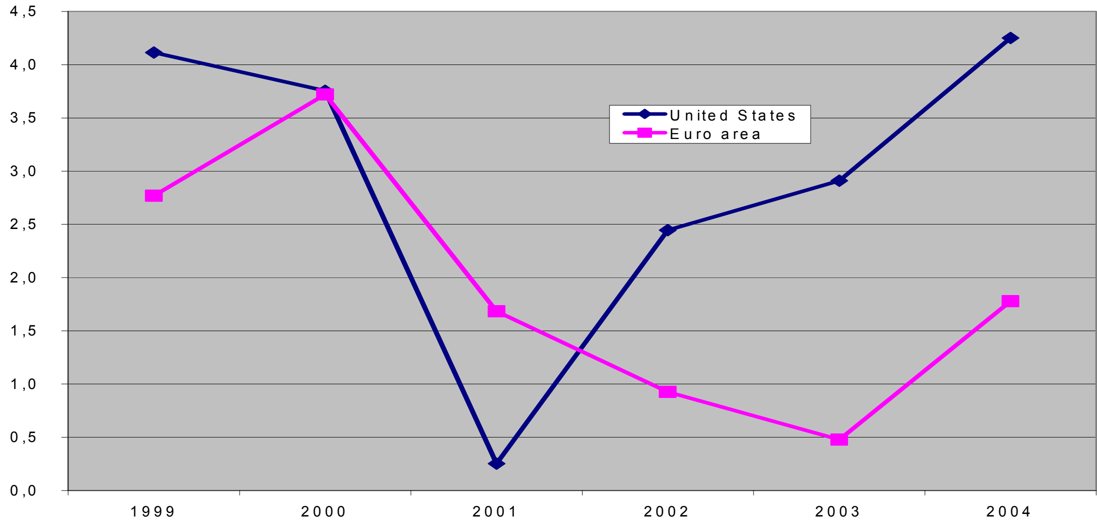
[1] E.g. the Broad Economic Policy Guidelines 2003 required: "Maintain budgetary positions of close to balance or in surplus throughout the economic cycle, and as long as this has not yet been achieved, take all the necessary measures to ensure an annual improvement in the cyclically-adjusted budget position of at least 0.5% of GDP."

[2] Resolution of the European Council on the Stability and Growth Pact, which was decided at the Amsterdam European Council on 16 and 17 June 1997,

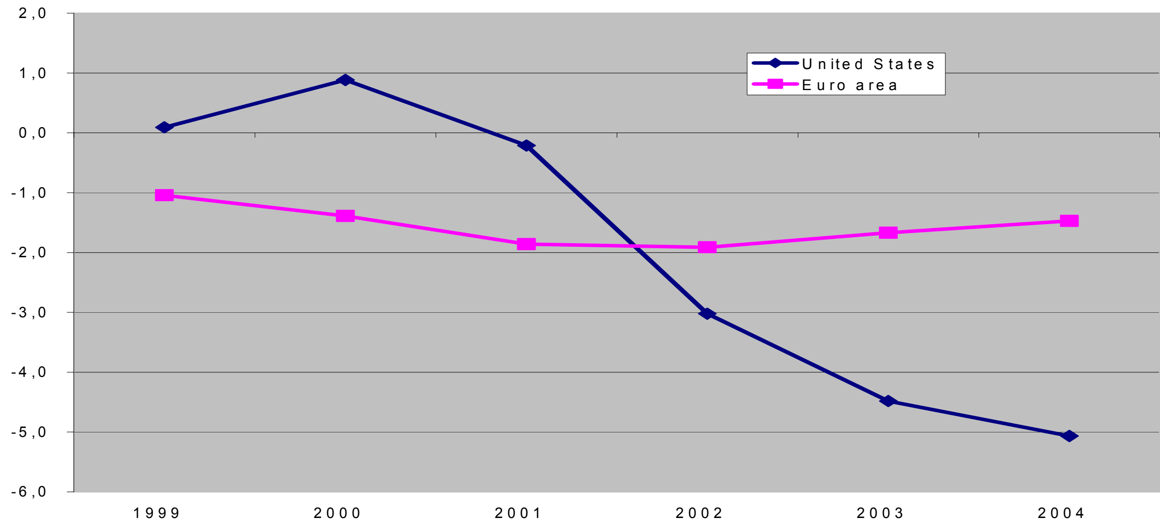
Chart 1: Real GDP growth



Source: OECD, Economic Outlook, December 2003

Many observers are inclined to attribute the superior outcome of the United States to a higher degree of flexibility in labour and goods markets and to a lower share of public expenditures in GDP. However, a look at simple macroeconomic indicators makes clear that the main explanation is macroeconomic. The driving force behind the dynamism in the United States was a much more active role of both fiscal and monetary policy. Chart 2 shows that from 2000 to 2004 the structural deficit of the United States experienced a negative swing of 6 percentage points. In the same time the swing in euro area was not more than 1 percentage point. In other words, while the fiscal policy in the United States has followed a strong anti-cyclical policy stance, in the euro area aggregate fiscal policies have shown almost no reaction to the severe demand shocks that took place in 2001.

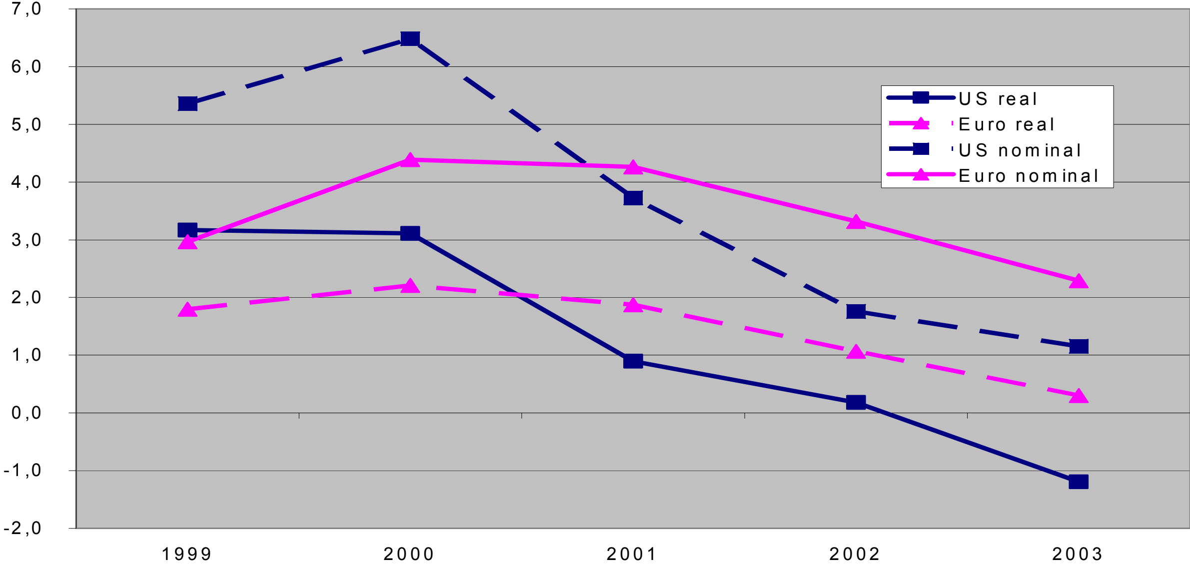
Chart 2: Structural Balances



Source: OECD Economic Outlook, December 2003

This almost passive role of fiscal policy is even more problematic since the ECB has responded to the weakening of the economic situation much less and much slower than the Federal Reserve. This is reflected by Chart 3 which shows that the reduction of the nominal and real short-term rate in the United States was about 4 percentage points, while it was only 2 percentage points in the euro area.

Chart 3: Short-term interest rates



Source: OECD, Economic Outlook, December 2003

Thus, in retrospect the main macroeconomic players in the euro area have adopted a much less active role than in the United States. Together with the depreciation of the dollar this insufficient macroeconomic stabilisation can be regarded as the main reason for the underperformance of the euro area in the last few years.
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The insufficient response of the aggregate fiscal policy stance is due to a predominance of pro-cyclical fiscal policies at the national level. This is shown in Table 1 which is based on annual data form the OECD Economic Outlook. As a very rough approximation it identifies a fiscal policy as pro-cyclical (P) if it

- intensifies a downturn: this is the case if the output gap is negative and if the structural deficit is reduced (or if a structural surplus is increased), or
- intensifies an upswing: this is the case if the output gap is positive and if the structural deficit increases (or if a structural surplus is reduced).

If the change in the structural balance is no more than ± 0.2% a policy is marked as “neutral” (N).

Table 1: Fiscal policy stance in EU member countries

	1999/2000	2000/2001	2001/2002	2002/2003	2003/2004	∑ *P*	∑ *A*
Austria	N	A	N	A	P	*1*	*2*
Belgium	P	A	P	P	N	*3*	*1*
Denmark	P	A	A	N	N	*1*	*2*
Finland	A	A	A	A	P	*1*	*4*
France	P	N	A	N	P	*2*	*1*
Germany	P	A	N	P	P	*3*	*1*
Greece	A	A	N	P	N	*1*	*2*
Ireland	A	P	P	A	N	*2*	*2*
Italy	A	P	A	P	P	*3*	*2*
Netherlands	A	P	N	A	P	*2*	*2*
Portugal	P	P	A	P	N	*3*	*1*
Spain	A	A	A	P	N	*1*	*3*
Sweden	A	P	A	N	N	*1*	*2*
UK	N	P	P	A	N	*2*	*1*
Euro area	**A**	**P**	**N**	**P**	**P**	***3***	***1***
∑ *P euro area*	*5*	*4*	*2*	*6*	*6*		
∑ *A euro area*	*6*	*7*	*6*	*4*	*0*		

For the period from 1999 to 2004 this simple exercise shows that in the euro area as a whole an anti-cyclical policy stance was achieved only in the year 1999: in this year the output gap was negative and the structural deficit increased from 1999 to 2000. In three years fiscal policy was pro-cyclical and in one year neutral. In Belgium, Germany, Italy and Portugal there were three episodes with a pro-cyclical policy. The positive examples are Austria, Denmark, Finland, Greece and Spain which both recorded only one year with a pro-cyclical policy.

As the table shows the pro-cyclical policy stance increased in the last few years. This outcome is clearly related to the inflexibility of the SGP. In countries which reached the 3 % threshold or which were close to it, above all Germany, France, and Italy the simple SGP rule leaves no alternative to a pro-cyclical policy stance. In Spain and Belgium the pro-cyclical stance can be explained with the desire to achieve a balanced budget irrespective of the overall macroeconomic situation in the euro area.

4. The SGP as "a means to strengthening the conditions for price stability".[3]

The German fears, which led to the creation of the SGP, were based on the experience of the 1970s and 1980s when some countries, notably Italy, with high deficits and a high debt level experienced double-digit inflation rates. However, it was obvious already in the 1990 that the link between public debt or deficits and inflation is very weak, at least in OECD countries with relatively moderate inflation rates.

- First, the public perception that a high government debt leads to inflation mainly warranted if the government can finance its deficits by printing money. However, this option, which was available to some EU countries in the 1970s and 1980s, is explicitly excluded by Article 101 of the Treaty.
- Second, a high deficit can be due to excessive government spending which could create inflationary pressure but it can also be caused by weak economic growth which is

[3] Resolution of the European Council on the Stability and Growth Pact, which was decided at the Amsterdam European Council on 16 and 17 June 1997,

associated with deflationary tendencies. In the case of Germany the budgetary problems are clearly related to the economic stagnation since 2001. The negative correlation between deficits and inflation is enhanced by the Phillips curve. In Germany the weak growth has led to moderate wage increases so that the German inflation rate is the lowest in the euro area. This process is additionally furthered by the uniform nominal interest rates, which lead to relatively high real rates in countries with weak growth.

Thus, if the SGP is interpreted as a framework, which strengthens the conditions for price stability, it would make no sense to sanction Germany or France since both countries have not been responsible for inflationary tendencies in the euro area. On contrast, countries with "sound public finances" like Ireland, Spain and the Netherlands have shown relatively high inflation rates. Thus, the SGP in its present form is unable to provide a "support of stability oriented monetary polices". In fact, more restrictive fiscal policies in Germany and France would have widened the inflation differential within the euro area so that a stability-oriented monetary policy of ECB – which can only target the average inflation rate – would become more difficult.

In sum, as an anti-inflation device the SGP is neither sufficiently specific nor sufficiently sensitive:

- It identifies countries as "inflationary" which like Germany are at the brink of deflation.
- It fails to identify countries with inflationary tendencies like Ireland and the Netherlands in 2000 since they have not reached the 3 % threshold.

5. The contribution of the SGP to sustainable fiscal positions

While the importance of sustainability is widely agreed, there is an obvious lack of theoretically derived benchmarks. In contrast to monetary theory which developed important heuristics for policy makers in the last decade, the theory of fiscal policy has not been able to derive quantitative rules for sustainable *debt to GDP ratios*. Without such a benchmark it is also not possible to derive a permissible value for the *deficit to GDP ratio,* which determines the path of the debt to GDP ratio over time.

The Maastricht Treaty solved this problem in a pragmatic way by defining the average debt to GDP level of the year 1990 as benchmark. It derived the 3 % threshold under the assumption that deficits of that size would keep a 60 % debt ratio constant as long as nominal GDP grows 5 % per annum. While this approach lacks a theoretical basis, it at least is in line with the traditional structure of national financial markets.

The SGP avoided this difficulty simply by requiring a balanced budget irrespective of the concrete debt ratio. This approach reminds of the "golden rule of public finance" which allows deficits as far as they are used to finance public investments. The golden rule is based on the intuitive idea that public investments, which can be used, of a longer period of time need not be paid immediately with taxes. As public investments in the euro area equal about 2.5 % of GDP, this rule would come relatively close to the original 3 % benchmark of the Maastricht Treaty.

The much stricter balanced-budget rule of the SGP is more difficult to justify. In fact, the designers of the pact never tried to provide such a theoretical explanation. The only rationale of this heuristic is a gradual reduction of the ratio of public debt to GDP to zero. With a 5 % growth rate of nominal GDP a debt level of 60 % to GDP is reduced to 15 % in 30 years and

to 9 % in 40 years. Given an increasing demand for safe investments for the build-up of capital-funded pension schemes it is very questionable whether a long-run debt to GDP ratio of zero constitutes an optimum solution for the euro area countries.

6. How to reform the SGP?

There is no doubt that the specific environment of EMU requires a set of rules for national fiscal policies. Based on the experience of the last few years and the intensive discussions among academics and politicians there are three main objectives for such rules:

- The overall fiscal policy stance of the euro area should be compatible with the current macroeconomic situation and consensus forecasts.
- National fiscal policies should not become a source of inflationary pressure to which the ECB cannot respond directly.
- National debt levels should follow paths that are sustainable in the long-run.

It has been shown that SGP in its present form has been unable to meet the first objective. As far as the second objective is concerned, the SGP is not sufficiently specific as it identifies countries with deflationary tendencies as a risk to price stability. The difficult objective of debt sustainability is solved by SGP's rule of a balanced budget which implies a long-term target value of zero for debt/GDP levels.

In sum, it is very difficult to agree with Buti et al. (2003, p. i) who argue that "the EU fiscal rules work quite well". This applies above all as the problem of the aggregate policy stance is of much more relevance today than the risks of inflation or unsustainable debt levels.

Thus, the current debate on the SGP should be regarded as an opportunity to go beyond partial reforms of the SGP. In the last few years the ECB has recognised that a simple rule and even a reference value for monetary policy is inadequate given the complexity of the world. In the same way, it should be realised that the simple rule stipulated by the SGP is not able to meet the complex requirements for fiscal policy co-ordination in EMU. Instead a comprehensive fiscal policy framework is required that would meet the three objectives more specifically than the SGP. In this short paper only a very rough outline of such a framework can be presented:

- The projected *overall fiscal policy stance* of the euro area should play an essential role. In situations where an aggregate pro-cyclical or neutral policy stance is expected, countries with a pro-cyclical stance should be advised to adjust their budgetary policies. A proposal along these lines was made by the former French Finance Minister Dominique Strauss-Kahn at the informal Ecofin Council in Dresden in April 1999. Buti et. Al (2003, p. 19) argue that this proposal would lead to national deficits of more than 3 % which they regard as incompatible with the Maastricht Treaty. However, it is important to note that Article 104 is less strict than the SGP since it allows higher deficits than 3 %, if "the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value".
- For the *avoidance of inflationary policies* at the national level, a monitoring only of countries with an inflation rate that exceeds the ECB's 2 %-inflation target by more than e.g. one percentage point is required. Such a monitoring should try to identify the causes

of the excessive inflation. For countries with a positive output gap and an increasing structural deficit (or a decreasing structural surplus), the sanctions along the lines of the present SGP could be applied.

- For *safeguarding the sustainability of national debt levels* Article 104c in its present form seems already sufficient. With the 60%-benchmark it identifies a benchmark for debt sustainability which leaves more room for different national requirements, above the prevailing structures of financial markets, than the completely arbitrary 0%-benchmark which is implicitly set by the SGP. In this area more research efforts are needed to identify debt/GDP levels that are sustainable in the long-term.

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