

The Maastricht Dog That Lost Its *Bark*

*How the Stability Pact
has lost its relevance.*

BY DANIEL GROS, THOMAS MAYER, AND ANGEL UBIDE

THE INTERNATIONAL
ECONOMY

THE MAGAZINE OF
INTERNATIONAL ECONOMIC POLICY

2099 Pennsylvania Avenue, N.W.
Suite 950

Washington, D.C. 20006

Phone: 202-861-0791

Fax: 202-861-0790

www.international-economy.com

When large numbers of drivers ignore the speed limit, it is good practice to reconsider its rationale and, if reaffirmed, to tighten enforcement, especially if the frequency of accidents increases. Hence, the EU Commission was right in launching a debate about the Stability and Growth Pact, which has been violated by an increasing number of EMU member countries. Unfortunately, however, the Commission's proposals for reform risk watering down the Pact, resulting in an erosion of fiscal discipline. In our view, countries presently struggling with excessive deficits should implement reinforced fiscal adjustment programs. The case for a consolidation of government finances against the background of present and prospective demographic changes remains very strong.

Daniel Gros is Director of the Centre for European Policy Studies, Brussels. Thomas Mayer is Chief European Economist at Deutsche Bank Global Markets, London. Angel Ubide is Director at Tudor Investment Corporation, Washington, D.C. This essay builds on their earlier publication, The Nine Lives of the Stability Pact, Special Report of the CEPS Macroeconomic Policy Group (CEPS, 2004).

THE LONGER-TERM OUTLOOK

The Stability and Growth Pact was created in order to make the general prohibition against “excessive” deficits in the Maastricht Treaty operational. The Treaty, which introduced the constraints on fiscal policy, started from the assumption that nominal GDP would grow at 5 percent per year on trend and that a debt ratio of 60 percent of GDP was bearable. Consistent with these assumptions, it stipulated that government budget deficits must not exceed 3 percent of GDP.

In hindsight, this deficit limit appears rather generous. Reflecting the European Central Bank’s inflation target of less than 2 percent and real potential growth of probably only around 1 percent in Euroland, a more realistic assumption for Euroland nominal trend growth is around 3 percent. To stabilize the debt ratio at 60 percent of GDP, the deficit would need to be capped at 2.1 percent. Moreover,

If the European fiscal policy framework

is to regain any credibility,

it must ensure that the “sinners”

behave better this time.

aging of the Euroland population raises government liabilities not included in the debt ratio in the Maastricht definition. Hence, to keep governments solvent, the latter should decline over time, ensuring that total government liabilities do not increase on trend over the next half century. These facts are generally accepted. However, nei-



ther they, nor their obvious implication that the conditions in the Stability and Growth Pact should be tightened rather than loosened, are reflected in the current proposals for reform coming out of the Commission.

Surprisingly, the Commission seems also to have ignored a key argument in favor of raising the threshold for invoking exceptional circumstances. With the potential growth rate having declined in most eurozone countries, it is much more likely that countries will experience phases during which growth is “slow” by historical standards. Hence, when potential growth is slowing, authorities need to continuously update their view about what is exceptionally “sluggish” growth. For example, a growth rate of 1.5 percent would most likely be considered “sluggish” by politicians when compared to the goal of 3 percent as agreed at the Lisbon summit. However, growth of 1.5 percent might already be very close to (and for some countries above) potential growth in reality, and thus not qualify as “sluggish.”

THE COMMISSION PAPER IN DETAIL

In its Communication of 3 September 2004, the Commission proposed a number of reforms with the stated aim of strengthening the Stability and Growth Pact, an aim we would support given our view that the Pact remains necessary. The Commission proposal addresses six main points:

- Prolonged periods of sluggish growth, which are to qualify as an “exceptional circumstance” where deficits of more than 3 percent of GDP are allowed;
- Country-specific elements in the enforcement and correction of excessive deficits;
- Country-specific elements in the definition of medium-term deficit objectives;
- Earlier actions to correct inadequate budgetary developments;
- Better links between general economic policy surveillance, fiscal policy surveillance, and national budgetary processes;
- Improved enforcement through “early warnings” directly issued by the Commission, better fiscal statistics, greater peer pressure, greater transparency and accountability of the member states’ budgetary policies, and closer involvement of national parliaments in fiscal policy coordination.

The European Union’s finance ministers, who will decide about any formal changes to the Stability and Growth Pact shortly, are likely to welcome the first three points of the Commission proposal for reform because they allow the ministers to rebalance the mix of discretion and rules embedded in the Pact in favor of the former. In our view, however, this is likely to result in a watering down of the Stability and Growth Pact as governments will always find excuses for an excessive deficit.

At first glance, allowing a period of sluggish growth to qualify as an “exceptional circumstance” (granting an exception from the 3 percent deficit limit) seems to recognize that the accumulated output gap over several years matters more for government finances than that of a single period. The output gap could be larger after a long period of positive growth below potential than after a short recession. However, a reduction in potential growth is often rec-

*History shows that the European Union
has never been able to pressure
countries to consolidate government
finances even during good times.*

*The Commission cannot really supervise
fiscal policy when it has only one full-
time official per member country on
average working in this area.*

ognized only after several years of weak growth. At the beginning of a period of lower growth it is difficult to decide whether this is temporary or permanent. The temptation to regard it as temporary will be impossible to resist when this has the implication that higher deficits are allowed.

Moreover, even on a purely technical basis, the experience of 2003 shows that output gap estimates are subject to large revisions as new data come in. For example, when the very low growth rate for 2003 was put in the EU Commission model for the German potential growth rate, the estimate of the output gap had to be revised downward substantially, with the consequence that the estimate of the cyclically adjusted deficit increased by almost 0.5 percent of GDP. Hence, the first two points of the Commission proposal appear to allow necessary adjustment to be delayed and hence create the risk of a sizeable accumulation of excessive deficits and debt.

More generally, quantifying potential growth is an extremely difficult technical judgment which leaves much room for disagreement even among experts, as one can see by looking at the differences in estimates of potential growth coming from such respected institutions as the OECD, the International Monetary Fund, and the European Central Bank. If estimates of potential growth rates acquire immediate political importance, it will be extremely difficult to shield the staff of the Commission from political pressure or to impede the Council to just come up with higher estimates. Therefore, the need for potential GDP growth estimates in the implementation of the Stability and Growth Pact should be minimized (although it cannot be entirely eliminated), and estimates should be carried out, if at all possible, by an independent institution.

The last three points of the Commission communication may find more widespread support. However, the budgetary surveillance procedures proposed by the Commission lack teeth. History shows that the European

Union has never been able to pressure countries to consolidate government finances even during good times. Hence, there is the serious risk that mostly lip service will be paid to this part of the Commission's proposals without much tangible action.

Nevertheless, one thing may change. After the revelation that Greece has been able to systematically underreport its deficit for a number of years, it has become obvious that the capacity of the Commission to scrutinize and evaluate fiscal policy in member countries must be reinforced. As we have already documented in prior work, the Commission cannot really supervise fiscal policy when it has only one full-time official per member country on average working in this area. Manpower is scarcer for the smaller than the larger member countries. Hence, it is not surprising that in the case of Portugal, and more recently Greece, the Commission was not able to discover large discrepancies in reported deficits. The capacity of the Commission to check national data, both *ex post* and *ex ante*, and the budget plans for the current year, must be strengthened.

These data problems—together with the monitoring problems resulting from the very large budget forecasting errors, as we also documented in our earlier report—bolster the case for the establishment of independent national budget agencies. These agencies would improve monitoring and provide alternative forecasts as a reality check on optimistic government assumptions.

POLICY CONCLUSIONS

The Stability and Growth Pact was designed so that countries would be able to let automatic stabilizers work fully. For that, countries were required to achieve as soon as possible the desired starting point, namely a budget close to balance or in small surplus. The design of the Stability and Growth Pact would then allow countries to weather cyclical fluctuations while respecting the 3 percent limit. This background is important for understanding the Stability and Growth Pact fiasco, and it is essential to understand why the situation now is even worse than it was at the beginning of EMU. Why did some countries breach the 3 percent limit? Because they did not meet the commitment to achieve a budget position close to balance or in small surplus before the cyclical downturn of 2001–03. Thus, the Stability and Growth Pact parameters were no longer adequate. But the failure was due to domestic fiscal policy decisions, not to the Stability and Growth Pact parameters.

Today the situation is the even worse. There are two groups of countries: those that have the required budgetary starting condition of close to balance or small surplus, and those that do not. Any Stability and Growth Pact reparameterization is going to fail for the countries that do not

Markets do not impose discipline in Euroland—at least not now.

meet the initial requirement. If the European fiscal policy framework is to regain any credibility, it must ensure that the “sinners” behave better this time. Peer pressure for greater fiscal discipline has proven ineffective. Hence, the sinners must be required to publish detailed plans how they intend to achieve the desired initial budgetary conditions as soon as feasible. They must demonstrate ownership of these plans by investing political capital in them, for example by committing before their own parliaments to a rigorous three-year plan approved by the Commission and to report back any deviation before their parliaments. This procedure is a model used by the IMF for programs that have gone off-track: in this case, the authorities must make additional efforts to put the program back on track.

Current prospects are not very encouraging: the French plan to reduce the budget deficit to 2.9 percent in 2005 is almost entirely dependent on a transfer of 0.5 percent of GDP from the energy utilities in return for assuming pension liabilities. Not only does this worsen the long-term fiscal outlook, but it is a reminder of how France only managed to meet the Maastricht criteria via another one-off transfer—that time from France Telecom. Fiscal adjustment plans for Germany and Italy presently also lack the necessary rigor to achieve lasting reductions in deficits.

If the sinners do not make the extra effort, the Stability and Growth Pact will become an empty shell. When a country defaults on its debt, markets typically require an extra risk premium for its debt. The countries that “defaulted” on their commitment the first time must now pay an extra price to restore their credibility. Markets do not impose discipline in Euroland—at least not now. However, the prospect of a sudden awakening of markets to the lack of EU fiscal discipline should never be ruled out. The “sinning” countries must therefore provide additional collateral this time.

For the virtuous countries discipline should be focused on not letting the cyclically adjusted balance deteriorate, in order to prevent growth masking a deterioration of the underlying fiscal stance. It is maintenance work, rather than repair, but it is still needed. It is up to the Eurogroup to decide. But this may be the last chance to take forceful action against the sinners before the demographic shock starts hitting and debt levels start to accelerate. ◆