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THE STABILITY PACT: TWO OBJECTIVES, TWO RULES

The recent amendment to the Stability and Growth Pact places greater emphasis on automatic stabilisers, but it will not prevent Germany and France from transgressing the Pact's new rules, as well as its previous rules. The question of whether the Pact's surveillance instruments of fiscal policy are appropriate to its two missions remains open. The 3% cap on budget deficits is a poor way of warning of insolvency or preventing national fiscal policies from constraining monetary policy in the eurozone. Several ideas have been put forward for rules that are better adapted to meeting these objectives. As far as the second objective is concerned, this article proposes that the overall balance of savings and investment of each Member State should be monitored, rather than the public fiscal deficit. This would make it possible to identify when fiscal policy may be too tight to prevent a deflationary spiral from occurring. Such a policy would also facilitate the coordination of fiscal and monetary policies.

A Tight Corner

On 3 June 2003, the Ecofin Council requested that France provide the European Commission with a plan (within four months) for controlling its fiscal deficits in accordance with excessive deficit procedures. This request calls on France to reduce its deficit below 3% of GDP in 2004, while bringing down the structural deficit by 0.5 percentage points of GDP. In January 2003, an identical procedure was applied to Germany (following Portugal). The problems which the two largest countries of the eurozone face in respecting the Stability and Growth Pact (SGP) are not surprising. Before the euro was adopted, some economists (even within the European Commission) acknowledged that the transition phase to balanced public finances (1999-2004, according to original stability programmes) could indeed be a delicate process. This would be especially the case were growth to slow down [1]. If growth slows by one percentage point (falling from 3% to 2%, for example), then budget balances deteriorate by an average 0.5% of GDP, due simply to the workings of automatic stabilisers[2]. Consequently, a country with a deficit equivalent to 2% of GDP will not be able to deal with a fall in growth of more than 2 percentage points without breaching the 3% deficit threshold. Thereafter, the country will find itself having to apply a restrictive, pro-cyclical fiscal policy. Growth in the eurozone slowed by 2.7 percentage points between 2000 and 2002, the transition occurring in 2001.

Table 1 illustrates the extent to which public finances in Austria, France, Germany, Greece and Portugal were little improved in 2000, the year when growth peaked. All of these countries (barring Greece) experienced a slowdown in growth in the order of 2-3% between 2000 and 2002, with the result that public

Table 1 – The automatic impact of a slowdown in activity on public finances

	Fiscal balance (% of GDP)	Output Gap (% of potential GDP)		Sensitivity of fiscal balance to GDP[1]	Fiscal balance in 2002		Direction of fiscal policy[3]
	2000	2000	2002	(a)	Theoretical[2]	Observed	2002-2000
Austria	-1.5	1.8	-1.5	0.5	-3.2	-0.6	-
Belgium	0.1	1.3	-1.9	0.6	-2,0	0,0	-
Finland	6.9	2.4	-0.9	0.7	4.6	4.7	0
France	-1.4	1.2	-0.2	0.5	-2.1	-3.2	+
Germany	-1.1	1,0	-1.3	0.5	-2.3	-3.6	+
Greece	-1.9	-1.1	0.8	0.4	-1.1	-1.2	0
Ireland	4.5	6.8	5.8	0.5	4,0	-0.3	+
Italy	-0.7	0,0	-1.6	0.5	-1.5	-2.5	+
Netherlands	2.2	2.8	-1,0	0.8	-0.8	-1.1	0
Portugal	-2.9	2.1	-1.1	0.5	-4.5	-2.7	-
Spain	-0.6	0.4	-0.8	0.6	-1.3	-0.2	-
Eurozone	0.1	1.1	-0.9	0.5	-0.9	-2.3	+

1. Sensitivity to the fiscal balance (in % of GDP) to a 1% variation in GDP. *Source*: M. Buti & A Sapir (1998), *Economic policy in EMU*, p. 132, Oxford: Clarendon Press.
2. Theoretical balance$_{2002}$ = Balance$_{2000}$ + a (output gap$_{2002}$ - output gap $_{2000}$).
3. There was a discretionary expansion in 2002 with respect to 2000 (+) if the observed balance < theoretical balance. Fiscal policy was restrictive (-) if the observed balance > theoretical balance, and limited to automatic stabilisers (0) if observed balance = theoretical balance.
Statistical source: OECD, *Economic Outlook*, May 2003.

1. The European Commission's report *Economic Policy in EMU*, dated 1998 (M. Buti and A. Sapir *eds*, Oxford University Press) noted that: "In the event of a severe recession during the early years of EMU, since several countries will still have deficits in the 2-3% of GDP range, they risk moving into excessive deficits, unless they pursue pro-cyclical fiscal policies", p. 126.
2. See the Commission report..

finance balances worsened automatically by between 1 and 1.5 percentage points. Austria, Belgium, Portugal and Spain have tackled their worsening public finances by adopting pro-cyclical fiscal policies. In contrast, France and Germany have supported activity not just through automatic stabilisers but also by discretionary, expansionary policies.

At the Ecofin Council on 7 March 2003, Ministers of Finance amended the SGP so that Member States could use automatic stabilisers: the goal of a budget "near balance or in surplus" should henceforth be appreciated over the whole of the business cycle. At the same time, the speed of consolidating public finances is measured using a structural balance, in other words a balance adjusted for the cycle, which should improve by 0.5% of GDP per annum. An important consequence of this modification is to prevent Member States from distributing "fiscal windfalls" during phases of growth. States therefore face symmetrical obligations during the high and low phases of the cycle, and, in time, pro-cyclical policies will be proscribed.

These alterations to the SGP, however, do nothing to alleviate France's and Germany's problems in the short term. These two countries contravene both the old and new forms of the Pact, as their budget deficits exceed levels due to automatic stabilisers.

The impact of automatic stabilisers is not negligible, as they reduce fluctuations in activity by about 30%: this restricts a 1% fall in growth to 0.7%. But, this impact may be judged as insufficient when growth is hovering around 0%, as was the case for Germany in 2002. Is it then absolutely vital to prevent discretionary fiscal policies in the eurozone for countries which have not previously consolidated their public finances enough to achieve a balanced budget? This raises fundamental questions about the SGP's *raison d'être*.

Adapting Rules to Objectives

The SGP has two essential missions within the framework of monetary union. The first is to warn of any risks concerning the insolvency of a Member State which may threaten the stability of the financial system within the zone: the ECB could then find itself forced to create money which would run counter to its objective for ensuring price stability. Market expectations of such risks could then push up long term interest rates in the zone[3]. The second reason for the SGP stems from the existence of short term externalities within a monetary union relating to the execution of fiscal policy. The aim is to avoid fiscal permissiveness by a Member State which may follow on from the fact that any rise in interest rates is not centred on the State, but falls on all members of the monetary union, affecting most those countries that are fiscally virtuous. An unfavourable policy mix may be feared at the level of the union if fiscal policy is too expansionary and monetary policy too restrictive.

It is possible to question the merit of these two missions, noting in particular that an expansionary fiscal policy in one Member State, in the short term, carries both a negative externality (via the zone's interest rate) and a positive one for its partners (via trade). However, the agreement reached in Amsterdam in 1997 provides these missions with political legitimacy, which so far has not been challenged. Under these circumstances, it is more appropriate to examine the relevancy of the instruments (the stability programme, the 3% rule) than the objectives. But it is precisely here that the difficulties lie.

As far as preventing risks of insolvency is concerned, it must be stressed that a State's solvency depends more on the evolution of its public debt than on the value of its deficits. The deficit rule is too strict in the long term, as the balance of public finances (including debt interest) leads to public debt levels converging on zero, which is unlikely to be an optimal solution. In contrast, the rule is not strict enough in the short term for heavily indebted countries. If nominal output growth is not sufficient, a 3% deficit may lead to further debt increases. J. Pisani-Ferry has proposed that Member States should be given the possibility of opting for a "Sustainable Debt Pact". This would include an obligation to maintain the gross debt ratio below a certain threshold (he suggests 50%). Countries would also have to provide figures for "off balance-sheet" commitments, including public pension scheme liabilities. Countries opting for this Pact would be exempt from sanctions if they fail to meet the SGP[4]. Monitoring debt levels would require improving and harmonising statistics on assets produced by Member States, so that "net public wealth" can be evaluated[5]. Such a change appears inevitable.

With respect to preventing negative externalities, it should be remembered that an expansionary (though sustainable) fiscal policy in a member state does not necessarily raise the interest rate in the whole of the eurozone. This would need inflation to rise in the country in question and then lead the ECB to raise its rates to prevent any automatic rise in the eurozone price index. Alternatively, it would need for the State running a deficit to draw on savings within the eurozone to such an extent that real interest rates in the zone rise. In either case, fiscal policy in the country in question would have to stimulate demand for goods and services relative to supply (the inflation argument) or relative to savings (the savings-investment balance argument). Accordingly, a country that uses fiscal policy to counteract a *specific*, negative demand shock in the private sector (consumption or investment)

3. See B. Eichengreen & Ch. Wyplosz (1998), "Stability Pact: More than a Minor Nuisance?", *Economic Policy*, vol. 13, No 26, pp 66-113.
4. J. Pisani-Ferry (2002), "Fiscal Discipline and Policy Coordination in the Eurozone : Assessments and Proposals", <www.pisani-ferry.net>. D. Gros has suggested adding (rather than substituting) an obligation for States to reduce their debt ratio progressively to 60%, a ratio which is compatible with a 3% deficit and nominal growth of 5%. See D. Gros (2003), "A Stability Pact for Public Debt?", CEPS Policy Briefs No 30, January.
5. See B. Coeuré & J. Pisani-Ferry (2003), "A Sustainability Pact for the Eurozone", February, <www.pisani-ferry.net>.

would not be exerting inflationary pressure. The case of a symmetric shock would be different: an expansionary fiscal policy in a country may limit the fall in interest rates throughout the zone, which would be unfavourable to fiscally virtuous countries. The coordination of fiscal policies could be a tool for avoiding this type of unfavourable policy mix[6].

The budget deficit criterion thus meets the objectives of the SGP poorly. It says nothing about the sustainability of debt, nor about the scale of economic policy externalities. If the level of indebtedness, complemented by information on assets and off balance-sheet liabilities provide ways of gauging the sustainability of public finances, what indicator could be used to measure the scale of externalities?

The Right Balance

One idea, put forward by C. Mathieu and H. Sterdyniak[7], would be for each country to fix objectives in terms of inflation, rather than public finances. Each Member State would then be obliged to hold its inflation rate within a target range. The target would be stricter in "northern" countries than in "southern" countries, as economic catch-up by the latter leads to faster price rises within a monetary union. This proposal is attractive, in as much as it makes it easy to single out the country or countries whose excessive inflation could put upward pressure on interest rates in the zone. However, establishing such objectives would necessarily be conditioned by the ECB maintaining its 2% inflation target for the zone, and this could somewhat weaken efforts by Member States. Furthermore, fiscal policy only acts on inflation with a lag, so that expected inflation would have to be targeted. This would be difficult to implement given the presence of changing political majorities.

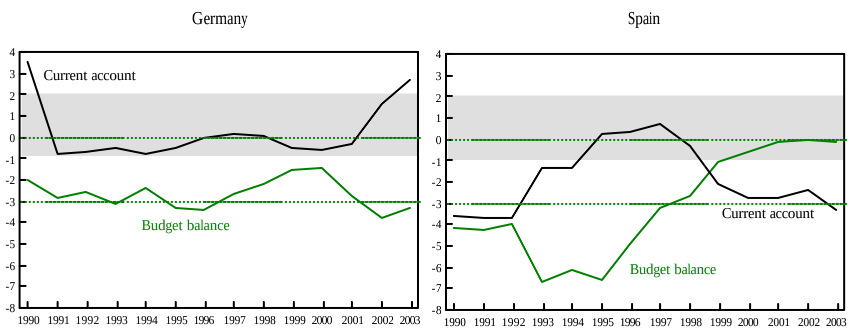
Along similar lines, it could be possible to monitor not the public deficit but rather the overall savings-investment balance of each Member State, in other words its current account balance. Insufficient private savings put as much pressure on interest rates in the eurozone as does insufficient public saving. To be sure, the fiscal authorities have little means for influencing savings-investment imbalances in the private sector. But then, isn't it the role of an active fiscal policy to compensate for fluctuations originating in the private sector? In addition, if the value of the euro is a collective good for Member States, then it would be logical to target the current account and not the budget balance. Lastly, focusing on the external balance would make it possible to identify those countries with excessively restrictive fiscal policies (shown by excessive surpluses), and so avoid the triggering of a deflationary spiral. Also, it would commit Member States to reducing their deficits during phases of strong internal demand growth, rather than distributing "fiscal windfalls".

The target for the current account balance could be varied over time, and discussed within the framework of the BEPG[8]. Given its demographic ageing, the eurozone could fix a current account target that is slightly in surplus, equivalent to about 1% of GDP, per annum. This figure corresponds to the order of magnitude put forward by J. Williamson[9] for calculating long term real equilibrium exchange rates. This can be illustrated using an example, say, by adopting a current account target ranging from -1% to +2% of GDP, equivalent to the 3 percentage point range for public deficits set by the SGP. Each Member State should commit itself to varying its deficit in a way that is coherent with the current account norm, either by pursuing an expansionary policy in the case of an excessive current account surplus or through restrictive policy when running an excessive current account deficit.

Good and Bad Performers

A fiscal rule based on the current account rather than not the fiscal deficit would amount to a complete overhaul of fiscal policies in the eurozone. This is illustrated by comparing Germany's bad performance in 2002 with Spain's excellent record on turning around its public finances spectacularly (see graph). A current account norm would have required Germany to run an expansionary fiscal policy in 2002, and Spain a restrictive one.

Graph — Fiscal and Current Account Balance in % of GDP



NB: The dotted green lines indicate the fiscal rule and the grey, shaded zone the current account rule.
Statistical source: OECD, Economic Outlook, May 2003.

6. In fact, symmetric and asymmetric shocks occur all the time. Jacquet and Pisani-Ferry suggest that coordination takes place up stream, in the fixing of rules for reacting to macroeconomic shocks. However, problems of identifying shocks make it difficult to implement this proposal. See P. Jacquet & J. Pisani-Ferry (2000), "La coordination économique dans la zone euro : bilan et propositions", in CAE, *Question Européennes*, rapport No 27, La Documentation française.
7. C. Mathieu & H. Sterdyniak (2003), "Réformer le pacte de stabilité : l'état du débat", *Revue de l'OFCE*, No°84, January.
8. Broad Economic Policy Guidelines. The BEPG are fixed by the European Council and approved annually by the Ecofin Council. If economic policy does not conform to these Guidelines, the Council may address recommendations to the Member States.
9. J. Williamson & M. Mahar (1998), "Current Account Targets", Appendix A, in S. Wren-Lewis & R. Driver (*eds*); *Real Exchange Rates for the Year 2000*, Policy Analyses in International Economics 54, Washington DC: Institute for International Economics. .<www.iie.com/publications/chapters_preview/19/appaiie2539.pdf>.

Table 2 indicates the position of the Member States in the eurozone[10] both as a function of their fiscal and current account balances. For the latter, it uses the norm defined above (a target range from -1% to +2% of GDP). If the theory concerning the existence of twin deficits is verified, then countries should be positioned on the second diagonal (which runs from the north-west of the table to the south-east). This is clearly not the case, as Member States may be found in nearly all boxes of the Table.

Table 2 – The position of Member States in 2002, according to the two criteria

	Fiscal stance in balance or surplus	Moderate fiscal deficit (between 0 and 3% of GDP)	Excessive fiscal deficit (more than 3% of GDP)
Excessive current account surplus (more than 2% of GDP)	Belgium Finland	Netherlands	Germany France
Current account balance (between –1% and +2% of GDP)	Ireland	Austria Italy	
Excessive current account deficit (balance worse than –1% of GDP)	Spain	Greece	Portugal

Stattistical source: OECD, Economic Outlook, May 2003.

The SGP recommends that countries in the last column of the table cut their deficits, in the short term, as should countries in the middle column, over the medium term. These recommendations work in the same direction as a rebalancing of current accounts would for Portugal and Greece, but in opposing directions for Germany, France and the Netherlands. In contrast, the SGP makes no fiscal demands on countries located in the first column, though only Ireland actually finds itself conforming to the current account rule given here.

A drawback of such a current account rule stems from the fact that it does not take into account the catching-up of Member States, and hence their needs in terms of a savings-investment imbalance. But the SGP does not take into account the specific public investment needs of southern countries and of future EU members. The current account target range could thus be altered according to Member States' per capita GDP, by accepting a transition phase during which external deficits could rise to, say, between 3 and 5% of GDP.

Should there be a symmetric, external demand shock, then there is clearly a risk that all current account balances will move outside the accepted range. There would then be a case for holding discussions with the ECB. Indeed, an excessive surplus for the eurozone would signify that supply exceeds demand, leading to deflationary pressures, whereas an excessive, aggregate deficit indicates, in principle, inflationary tensions. Coordination between fiscal and monetary policies would perhaps be facilitated if both were based on the same accounts (the imbalance between aggregate savings and investment) which is not broken down between the public and private sectors, but rather by country. Overall, taking current account balances into consideration would be compatible with the Maastricht Treaty (article 109J) which, among the secondary criteria for entering monetary union states that "the reports of the Commission and the EMI shall also take account of [...] the situation and development of the current accounts".

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10. Luxemburg excluded.

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