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Bad weather for the Stability and Growth Pact

Everywhere in the world, the need for fiscal stimulus has caused a severe deterioration of fiscal balances and raised the unavoidable question of debt sustainability. In the Euro area, the recent initiation of Excessive Deficit procedures by the European Commission against the countries with high deficits has heated this debate. Still, the Euro area needs a credible scheme of budgetary discipline that would allow fiscal authorities to reassure sovereign debt markets and to dissipate the reticence of the ECB in adopting a policy of quantitative easing. That would also facilitate the implementation of fiscal stimulus packages, which could open an exit away from the crisis. Such a scheme should be designed to enforce more discipline, but also more counter-cyclical fiscal policies.

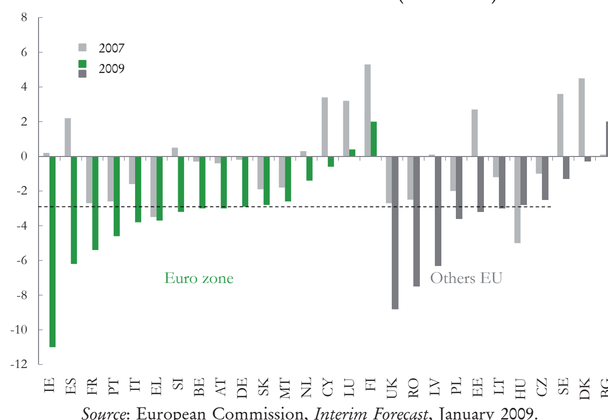
Slipping deficits

On February 18th, 2009, the European Commission launched excess deficit procedures for Ireland, Greece, Spain, France, Latvia and Malta. All six countries posted budget deficits exceeding 3% of gross domestic product in 2008. This is the first time such a large number of countries violates the Stability and Growth Pact (SGP). However, in 2009, most members of the Eurozone will likely cross the 3% threshold. Although the "exceptional circumstances" provision should apply here, given the fall in GDP across the Union, it is not yet clear how Member countries will come back to balance once the global crisis is over. Indeed, existing forecasts for 2010 are very uncertain, and few economists feel confident enough to make forecasts for 2011 and 2012. Hence, any commitment to reduce the fiscal deficit from 2010 is bound to be weak. Then, one question is that of the usefulness of the SGP today.

One striking feature of present fiscal imbalances is that the highest forecasted deficits are not necessary located in countries that, like France, failed to bring their budget back to balance before the crisis (Figure 1). Ireland, Latvia and Spain are impressive examples of how apparently healthy public finances can fall into dangerous territory in just a few months. The SGP may have excessively focused on public saving and not enough on private saving and contingent liabilities.[1] The lack of private savings in some countries may have artificially maintained tax receipts at a high level over the past; eventually, the collapse of private demand urges the public sector to substitute public for private demand, engineering an impressive deterioration of fiscal balances.

The very existence of the SGP is debated today since (i) it did not induce some Member countries like France to come back to balance before the crisis started, (ii) it did not prevent countries like Ireland to very rapidly fall into deficit when the crisis was there, and (iii) it does not provide any credible scheme for medium-run discipline. Still, the use of fiscal rules like the SGP has become common practice in advanced economies to provide guidelines for fiscal discipline.[2] Furthermore, sovereign bond markets, as well as central banks and taxpayers, need some credible guidelines to assess fiscal sustainability. The question then is no longer whether or not we need the SGP, but rather whether the SGP is well designed to provide a credible discipline device, despite the need of fiscal stimuli on the short-term.

Figure 1 – General government budget balance of EU-27 countries in 2007 and forecasts for 2009 (% of GDP)



Source: European Commission, *Interim Forecast*, January 2009.

1. See A. Bénassy-Quéré (2003), "The Stability Pact: two objectives, two rules", *La Lettre du CEPII*, no 224, June; and A. Bénassy-Quéré, A. Berthou & L. Fontagné (2008), "Euro : comme prévu, des gains et des coûts", *La Lettre du CEPII*, no 284, December.
2. For a survey of some of the fiscal restrictions recently implemented in other developed countries see S. Kennedy & J. Robbins (2001), "The Role of Fiscal Rules in Determining Fiscal Performance", *Department of Finance Working Paper*, 2001-16, Ministry of Finance, Canada.

Most of the literature analyzing the performance of fiscal rules in Europe tends to distinguish two periods: that of convergence, following the "Maastricht" Treaty in 1992; and from 1999 onwards that of implementation of the SGP. After a strong increase in fiscal discipline due to the admission criteria in the Euro area,[3] the SGP period witnessed some fatigue in fiscal consolidation.[4]

Maastricht more than the SGP

A usual way of analyzing the fiscal stance is to look at the cyclically-adjusted primary balance (CAPB), i.e. at the general government balance that (i) excludes net interest payments, and (ii) corrects for automatic stabilizers.[5] To better characterize the fiscal behaviors in the Euro area, we compare them to those of two other country groups: (i) a group comprising the three 'opt-out' Member States of the European Union (EU), that have chosen to remain outside of the Euro area (Denmark, Sweden, and the UK); and (ii) a group of six OECD industrialized countries that are not members of the EU.[6]

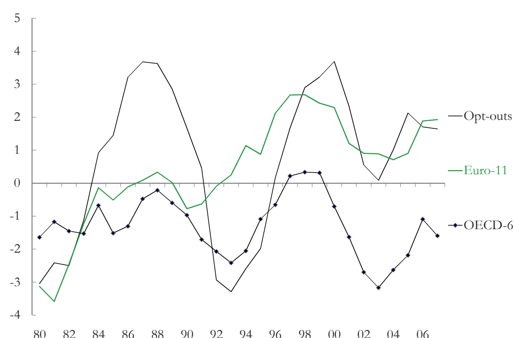
For the Euro-11 and "opt-out" groups, the average CAPB improved between the period pre-Maastricht and the SGP period: it increased, in % of GDP, from respectively -1.01 and +0.73 to +1.46 and +1.82 (Table 1). That improvement occurred during the intermediate period (Maastricht) when all three groups performed a fiscal consolidation, particularly the European countries (Figure 2). The latter – Euro-11 and Opt-outs – disposed of sufficiently high CAPBs around the year 2000 to keep those balances positive over the entire period of the SGP, in spite of the discretionary fiscal reactions to the macroeconomic downturn of 2001-2003.

Table 1 – Cyclically-adjusted primary balance (CAPB) in percentage of potential output – *Averages (unweighted) over the respective periods*

	Pre-Maastricht 1980-1991	Maastricht 1992-1998	SGP 1999-2007
Euro-11[a]	-1.01	+1.38	+1.46
Opt-outs[b]	+0.73	-0.87	+1.82
OECD-6[c]	-1.10	-1.10	-1.71

Notes: Euro-11: Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Netherlands, Portugal and Spain; Opt-outs: Denmark, Sweden and the United Kingdom; OECD-6: Australia, Canada, Iceland, Japan, Norway and the United States.
Source: OECD Economic Outlook no 83 and authors' calculations.

Figure 2 – Cyclically-adjusted primary balance (CAPB) in % of potential GDP



Source: OECD Economic Outlook no 83 and authors' calculations.

One of the essential rules of the SGP is that the total budget balance should not be lower than -3% of GDP, except under "exceptional circumstances".[7] Table 2 presents the number of times (years) that OECD countries had deficits higher than that value during the periods Maastricht and SGP (16 years in total). Greece has the highest number of excessive deficits (15), followed by Italy (13). Noticeably, the number of occurrences of excessive deficits falls strongly in all OECD groups during the SGP period; for the Euro-11 countries, this number plunges into a total of 30 occurrences (out of 99) when compared to the Maastricht period (54 out of 77). This is not only the result of the consolidation process occurred before 1999, but also due to the higher GDP growth rates throughout the period of the Pact. To isolate the role of the SGP in the evolution of budget balances, it is thus necessary to go beyond these simple observations.

Table 2 – Number of years of budget deficits higher than 3% of the GDP (1992 to 2007)

	Period Maastricht 7 years	Period SGP 9 years		Period Maastricht 7 years	Period SGP 9 years
Austria	4	1	Denmark	2	0
Belgium	6	0	UK	6	3
Finland	5	0	Sweden	5	0
France	6	3	Opt-outs	13/21	3/27
Germany	3	4	Australia	5	0
Greece	7	8	Canada	5	0
Ireland	0	0	Iceland	2	0
Italy	6	7	Japan	4	8
Netherlands	3	1	Norway	0	0
Portugal	7	5	USA	5	4
Spain	7	1	OECD-6	21/42	12/54
Euro-11	54/77	30/99	OECD-6	88/140	45/180

Source: OECD Economic Outlook no 83 and authors' calculations.

Disciplinary fatigue

Here, we aim to evaluate the changes of the CAPB in each of the different periods previously discussed, and to measure, in each of them, the discretionary fiscal reactions the business cycle and to excessive deficits. To do so, we estimate a reaction function that explains the CAPB-to-potential GDP ratio by five

3. Two of the five convergence criteria to become members of the Eurozone refer to fiscal balance: a deficit of less than 3% of GDP; a gross public debt of less than 60% of GDP.
4. See A. Fatás & I. Mihov (2003), "On constraining fiscal policy discretion in EMU", *Oxford Review of Economic Policy*, 19(1), pp. 112-131.
5. The rationale for excluding net interest payments is that these are largely out of control of the present government, since they basically depend on the inherited debt and on the market interest rate. In turn, correcting for the business cycle amounts to focusing on discretionary fiscal policy, as opposed to automatic stabilizers.
6. Australia, Canada, Iceland, Japan, Norway, and the United States.
7. The other rule consists in keeping the total budget balance (*i.e.* including net interest payments and without correcting for the business cycle) "close to zero or in surplus" over the medium run.

Table 3 – Impact of the MT and the SGP on the cyclically-adjusted fiscal balance

	CAPB reactions (in percentage points of the GDP)					
	to the period dummies[a]		to the output gap[b]		to the excessive deficits[b]	
	1992-1998 (1)	1999-2007 (2)	1992-1998 (3)	1999-2007 (4)	1992-1998 (5)	1999-2007 (6)
Euro-11	+0.65**	+0.62**	+0.18*	-0.11*	+0.27***	+0.21
Opt-outs	+0.70	+0.73	+1.06	+0.11	+0.36	-0.01
OECD-6	+0.42	-0.27	-0.05	+0.21	-0.01*	+0.07

Notes: [a] Difference compared to the period 1980-1991. [b] Change in the CAPB associated with a one percentage point increase in the variable considered. ***, **, * coefficient significantly different from zero at 1%, 5% and 10%, respectively. For the Opt outs and OECD-6, the coefficients and significance are extracted from Wald coefficient tests. See Poplawski Ribeiro (2009), *op. cit.*.

Source: OECD, Economic Outlook no 83 and authors' calculations.

economic and political variables: the lagged CAPB ratio, the lagged gross public debt-to-GDP ratio, the inflation rate, and the output gap, plus dummies for years of parliamentary elections. Then, using a similar methodology as in Galí and Perotti (2003),[8] the impact of the Maastricht treaty (1992-1998) and of the SGP (1999-2007) is analyzed through additive and interacted period dummies (Box 1).

The results are reported in Table 3. Columns (1) and (2) show that, for the Euro-11 countries, other things equal, the two periods Maastricht and SGP have induced to a statistically significant difference in the CAPB ratio compared to the period Pre-Maastricht: in both cases, the budget balances went up. For the two other country groupings, no significant changes happened between the two periods (non-significant coefficients of period dummies in Columns (1)-(2)).

The interaction of the period dummies with the output gap evinces a significant discretionary fiscal reaction to the business cycle only in the Euro-11 countries (see Columns (3)-(4)). During the Maastricht period, this reaction is countercyclical: a fall by 1 percent in the output gap (i.e. actual GDP growing 1 p.p. less than potential output) leads to a fall in the CAPB of 0.18% of potential GDP. On the contrary, during the period of the Pact, discretionary fiscal policy in Euro-11 appears pro-cyclical.

Finally, Column (5) shows that during the Maastricht period, European countries tended to introduce corrective action in case of excessive budget deficit: an increase of the total deficit in the previous year in one percent above the ceiling of three percent of the GDP would make the CAPB react positively by 0.27 percent of GDP. This is no longer the case during the period of the Pact (non-significant result). Overall, these findings confirm the disciplinary fatigue and procyclicality of fiscal policy in the Euro-11 after 1998.

The reform of the SGP (in March 2005) introduced more flexibility into the excessive deficit procedures, in particular by relaxing, adding specificity, and clarifying the availability of various escape clauses. But, how did this reform impact on the behavior of the CAPB? To answer this question, we replicate the previous analysis for the Euro-11 group, dividing the SGP period into the "old SGP" and the "new SGP". The results show that during the period of the reformed SGP, the CAPB ratio, other things equal, is slightly higher than the CAPB ratio from the years of the ancient Pact (Table 4). Moreover, the reaction to excessive deficits is highly significant and positive in the period of the reformed SGP, whereas not significant during the old SGP. However, during this very short period between the reform of the Pact and the beginning of the global crisis, Euro-11 countries enjoyed a buoyant economy, which facilitated fiscal discipline. On average, fiscal authorities did not use the upturn to undertake discretionary restrictions (see the non-significant impact of the output gap on the CAPB in that period in Column (4)).

Table 4 – Impact of the old (1999-2005) and new SGP (2006-2007) on the cyclically-adjusted fiscal balance

	CAPB reactions (in percentage points of the GDP)					
	to the period dumies[a]		to the output gap[b]		to the excessive deficits[b]	
	1999-2005 (1)	2006-2007 (2)	1999-2005 (3)	2006-2007 (4)	1999-2005 (5)	2006-2007 (6)
Euro-11	-0.10	+0.67*	-0.05*	+0.03	+0.04	+0.43***

Notes: See notes of Table 3..

Source: OECD, Economic Outlook no 83 and authors' calculations.

Box 1 – Testing empirically the effectiveness of the SGP

We test the effectiveness of the SGP via the estimation of the following fiscal reaction function[1]

$$capb_{i,t} = \alpha_i + \lambda_t + \beta \times X_{i,t} + \gamma \times Z_{i,t} + \varepsilon_{i,t}$$

where $i = 1,...,N$ et $t = 1,...,T$ denote respectively the country and year of the observation; $capb_{i,t}$ is the CAPB in % of potential GDP; α_i represents the country-fixed effects; λ_t the time-fixed effects; and $\varepsilon_{i,t}$ is a error term normally distributed. Vector $X_{i,t}$ contains the five economic and political control variables mentioned in the text. Finally, Vector $Z_{i,t}$ comprises our testing variables, namely time dummies referring to the period of the Maastricht Treaty (1992-1998) and SGP (1999-2007), to analyze changes in the level of CAPB during those periods. Those dummies are interacted with country-group dummies to compare the response of Euro-11 with the other two OECD groups of countries. To check if fiscal policy has been pro-cyclical during the MT- and SGP-periods, we interact all those (time and country) dummies with the output gap. Finally, we test the reaction of fiscal authorities to excessive deficits by constructing an excess-deficit variable equal to zero in the absence of excessive deficit, and equal to the excess of deficit in the opposite case..

1. see M. Poplawski Ribeiro (2009), "New evidence on the effectiveness of Europe's fiscal restrictions", *CEPII working paper*, forthcoming.

8. J. Galí & R. Perotti (2003), "Fiscal Policy and Monetary Integration in Europe", *Economic Policy*, vol. 37, pp. 533-572.

Lost discipline

Today, European governments are experiencing a very rapid deterioration of their fiscal balances, and they are squeezed between (i) the SGP that (still) requires an explanation on how they will come back to balance; (ii) the domestic and international pressures for additional fiscal stimulation, if needed; and (iii) the concern over bond markets in the face of fast-growing debts. Meanwhile, the ECB is pressured to proceed with quantitative easing through outright purchases of commercial paper, corporate bonds, and possibly also sovereign bonds. These various constraints and pressures have so far led to a policy-mix that, according to many analysts, undershoots the macroeconomic problems.

Fixing the SGP and reforming the European fiscal framework may appear a remote issue, whereas in the short run, everything should be done to stimulate the economy. Somewhat paradoxically, though, fixing the SGP may be the beginning of the solution rather than the end of it. Indeed, convergence programmes are unlikely to be credible before there are some signs of recovery. This is why sovereign debt markets are so nervous, and it may also be one reason behind the reluctance of the ECB to proceed with quantitative easing. Strengthening fiscal governance in Europe would help sovereign spreads to come down and the ECB to be more relaxed about quantitative easing. One can hardly blame markets or an independent monetary authority for hesitating to sign up a blank cheque to governments, especially to those with weak discipline record.

Then, the question is how to strengthen the SGP. Various proposals have been made. One involves establishing independent and nonpartisan government agencies, such as the Belgian Federalplanbureau. These agencies could be charged with identifying changes in the cyclical state of the economy, assessing the extent to which fiscal policy is consistent with medium-term objectives, and providing advice on various policy measures. Cooperation and exchange of information among those agencies would increase fiscal coordination in Europe without removing sovereignty of national fiscal policies, which would still be voted by national parliaments.[9] Other suggestions, which could be easily combined with independent agencies, consist in: (i) *strengthening* the role of the debt level in the SGP rules;[10] and (ii) creating *rainy day funds* that would allow Member states to fall into excess deficits when necessary, provided they have previously accumulated surpluses. While *rainy day funds* would not fundamentally alter the incentive problems at the root of the difficulties in the implementation of the SGP, they could give more room for counter-cyclical policies while helping countries to comply with the Pact.[11] Interestingly, those funds proceed with the same logic as the dynamic provisioning scheme that has been suggested to reduce the pro-cyclicality of bank lending.

Nonetheless, these different proposals do not address the failure of fiscal surveillance so far to account for externalities stemming from private sector imbalances. To re-balance macroeconomic surveillance, more weight could be given to Broad Economic Policy Guidelines (BEPG), a loose coordination device[12] that up to now has been largely evicted by the SGP rules.

In the coming months, some Member states of the Euro area may have to be rescued by their European partners, by the IMF or by a combination of the two. In all cases, some conditionalities will be likely applied. De facto, rescued countries will then lose some fiscal sovereignty for a while. In the longer run, fiscal deficits may be financed through a common Eurozone bond, which will necessitate a tighter framework. These practical consequences of the global crisis all point to tighter rules, hence some form of sharing of fiscal sovereignty. In the very short run, this could mean adapting SGP rules to the very uncertain economic outlook by designing contingent commitments that, beyond automatic stabilizers, would allow fiscal balances to further deteriorate in case there is no sign of recovery in the second half of 2009 while engineering fast rebalancing in case of a fast recovery.

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9. See L. Jonung & M. Larch (2006), "Improving fiscal policy in EU: the case for independent forecasts", *Economic Policy*, Vol. 21, no 47, pp. 491-534; and X. Debrun , D. Hauner & M. S. Kumar (2009), "Independent Fiscal Agencies", *Journal of Economic Surveys*, vol. 23, pp. 44-81.
10. For a formal analysis of such proposal see M. Poplawski Ribeiro, R. Beetsma, & A. Schabert (2008), "A comparison of debt and primary-deficit constraints", CEPR *Working Paper* no 6897, July.
11. See D. Franco, F. Balassone & S. Zotteri (2007), "Rainy Day Funds: Can They Make a Difference in Europe?", *Bank of Italy Occasional Paper* no 11.
12. Included in Article 99 of the Maastricht treaty.

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