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The New Member States and the Stability and Growth Pact: needs for adapting in the prospect of euro area membership?

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The New Member States (NMS) have to comply with the Stability and Growth Pact (SGP) rules: public deficits below 3% of GDP and public debts below 60% of GDP, although they cannot be subject to fines as long as they are not members of the euro area. Most of the NMS currently run higher than 3% of GDP deficits but lower than 60% of GDP debts. The implementation of the surveillance procedures had led 6 of the 12 NMS to be under an excessive deficit procedure (EDP) soon after they joined the EU.

Are the SGP rules adequate for the NMS? The SGP rules were not designed for catching-up countries, but for 'old member States'. In particular, the initial rules of the SGP did not account for investment needs. A Golden rule for public finances would be especially appropriate for the NMS, since it would allow them to borrow to finance investment needs that will benefit not only current but also future generations. We argue that SGP rules are not adapted for the NMS and that better rules should be introduced in the prospect of euro area enlargement.

Section 1 provides a brief assessment of the current situation of public finance criteria in the NMS. Section 2 considers the rationale of SGP framework for the NMS. Section 3 advocates for a better fiscal rule: the golden rule. Section 4 concludes.

1. The current macroeconomic context

1.1. The NMS and SGP requirements: 3% of GDP deficits and 60% of GDP public debts

6 of the 12 NMS that joined the EU in May 2004 had to face an EDP as soon as from July 2004: the Czech Republic, Hungary, Malta, Cyprus, Slovakia and Poland. The EDP was initiated because of higher than 3% of GDP deficits.

Contrary to euro area countries currently under an EDP, the NMS currently running higher than 3% of GDP deficits also run low debts (see Table 1). Since several member states were allowed to join the euro area despite higher than 60% of GDP debt levels (Belgium, Greece, Italy), the debt criteria has in practice been 'forgotten', although it is the relevant criteria in terms of default risk in a monetary union (but 60% is certainly not the adequate level).

Hence, some EU-15 countries (like Belgium) do not face any EDP since they run low deficits together with well above 60% of GDP public debts, while NMS are *de facto* in the worst position as concerns the implementation of Maastricht fiscal criteria: they are accused of running excessive deficits and requested to bring them below 3% of GDP, although theyndo not raise any default risk in terms of public debt. This illustrates once again the lack of rationale of the SGP fiscal rules.

Public debts are below 60% of GDP in most NMS, at the exception of Cyprus (70%) and Malta (77%) (see Table 2). In the NMS-8, public debts are well below 60% of GDP and have been rising in recent years only in the Czech Republic (from 13 to 36%), in Poland (40 to 46%) and in Slovenia (25 to 29%). It is important to recognise that these countries have huge investment needs related with their catching-up process (like is shown in Antczak et al., 2006).

Table 1. Member States under an excessive deficit procedure, 2005

In 2005	Government balance, % of GDP	Government debt, % GDP	Inflation, %	Current account, % of GDP
Germany	-3.9	68.6	2.0	3.8
France	-3.2	66.5	2.0	-0.8
Italy	-4.3	108.6	2.2	-1.2
Portugal	-6.0	65.9	2.2	-9.5
Greece	-3.7	107.9	3.5	-7.4
United Kingdom	-3.4	43.1	2.4	-2.1
Poland	-3.6	46.3	2.2	-3.2
Czech Republic	-3.2	36.2	1.7	-2.9
Hungary	-6.1	57.2	3.7	-8.4
Slovakia	-4.1	36.7	2.9	-6.6
Malta	-4.2	77.2	3.7	-9.9
Cyprus	-2.8	70.4	2.3	-5.8
EU-15	*-2.7*	*65.1*	*2.3*	*-0.1*
EU-25	*-2.7*	*64.1*	*2.3*	*-0.3/-0.4*

Source: European Commission, Autumn 2005 forecasts

Table 2. NMS: government variables and current account balances

% of GDP

	General Government balance, 2005	Gen. govt debt, 1999/2005	Gen. govt gross investment 1995[1] /2004	Gen. govt expenditure, 1995[1]/2005	Current account balance, 2004	Net FDI 2004	Share in Eu-25 GDP, 2004
Czech R.	-3.2	13.4/36.2	5.1/5.0	54.4/45.0	-5.2	3.6	0.83
Estonia	1.1	6.1/5.1	5.0/3.0	43.8/39.6	-12.7	6.9	0.09
Cyprus	-2.8	59.9/70.4	2.9/4.1	*37.3/44.1*	-6.0	3.0	0.12
Latvia	-1.2	12.6/12.8	1.9/1.5	39.3/36.4	-12.8	4.3	0.11
Lithuania	-2.0	23.0/20.7	3.4/3.5	36.1/34.8	-7.7	2.3	0.17
Hungary	-6.1	61.2/57.2	*2.9/3.6*	*49.9/49.5*	-8.8	3.5	0.78
Malta	-4.2	57.2/77.2	*4.9/4.4*	*43.6/50.7*	-10.3	8.0	0.04
Poland	-3.6	40.3/46.3	3.4/3.5	51.3/45.0	-4.1	4.7	1.88
Slovenia	-1.7	24.9/29.3	*3.2/3.4*	*48.9/47.2*	-2.1	0.9	0.25
Slovakia	-4.1	47.2/36.7	2.3/2.5	54.1/41.2	*-0.9 (2)*	*1.6 (2)*	0.32
EU-15	*-2.7*	*67.8/65.1*	*2.6/2.4*	*51.1/48.1*			95.4
EU-25	*-2.7*	*66.7/64.1*	*2.3/2.5*	*45.6/47.9*			100.0

Notes: (1) In italics: Cyprus: 1998, Hungary, Malta: 1999, Slovenia, EU-25: 2000; (2) in 2003.
Sources: European Commission, Autumn 2005 forecasts, IMF.

1.2. The NMS and negative spillovers

The NMS do not currently raise any risk in terms of negative externalities for their European partners in the prospect of euro area membership. In a monetary union, the negative spillovers to be feared are: inflation, current account deficits and public debt default risk.

In EMU a country running excessive **inflation** would at some point cause a rise in the central bank's interest rate. Table 3 shows that inflationary pressures are not an issue for most of the NMS: inflation is close to the nominal inflation criteria, except for Latvia (6.9%), Estonia (4.1) and to a lesser extent Hungary (3.5). At the end of 2005, CPI inflation was amongst the lowest in the EU-25 in the Czech Republic and Poland. In the catching-up process, more rapid inflation in the NMS than in the OMS would be expected through the Balassa-Samuelson effect.

Table 3. NMS and the convergence criteria

In 2005	Government balance, %GDP (1)	Government debt, % GDP (1)	Inflation, % (1)	Inflation, Dec. 05/ Dec. 04	Short-term interest rates	Long-term interest rates
Czech Republic	– 3.2/-3.7	36.2/36.6	1.7/2.9	1.6	1.9	3.5
Estonia	1.1/0.6	5.1/4.0	4.1/3.3	4.1	2.4	4.0
Cyprus	-2.8/-2.8	70.4/69.1	2.3/2.1	2.0	4.4	5.2
Latvia	-1.2/-1.5	12.8/13.0	6.8/6.0	6.9	3.1	3.9
Lithuania	-2.0/-1.8	20.7/20.2	2.6/2.8	2.7	2.4	3.7
Hungary	-6.1/-6.7	57.2/58.0	3.7/3.0	3.5	7.0	6.4
Malta	– 4.2/-3.0	77.2/77.4	3.1/2.6	2.5	3.2	4.6
Poland	– 3.6/-3.6	46.3/47.0	2.2/2.3	2.2	5.2	5.2
Slovenia	– 1.7/-1.9	29.3/29.5	2.6/2.5	2.5	4.1	3.8
Slovakia	– 4.1/-3.0	36.7/38.2	2.9/3.6	2.8	2.9	3.5
EU-15	*– 2.7/-2.7*	*65.1/65.2*	*2.3/2.2*	*2.1*	*2.6*	*3.6*
EU-25	*– 2.7-2.7*	*64.1/64.2*	*2.3/2.2*	*2.2*	*-*	
Criteria	*<3.0*	*<60*		*<2.5 (2)*		*<5.3(3)*

(1) Resp. estimate for 2005 and forecast for 2006, European Commission
(2) Average inflation in the 3 less inflationary countries over the last 12 months: 1.0 (0.8 in Finland and Sweden, 1.5 in the Netherlands) + 1.5.
(3) Average 10 year benchmark interest rate in 2005 in Finland, Sweden and the Netherlands: 3.3 + 2.0
Sources: European Commission, Autumn 2005 forecasts, Eurostat.

In EMU, **current account deficits** are a potential threat to exchange rate stability, but this externality is not currently taken into account in the European surveillance framework. Hence Spain runs a higher that 7% of GDP current account deficit while Germany runs a 4% of GDP surplus. In the past, the Spanish peseta would have been under pressure to depreciate, but now this constraint has disappeared. As long Spain runs a 0% of GDP government deficit, it is considered to be the good 'pupil' of the euro area, while Germany is blamed for running higher than 3% of GDP government deficits.

The NMS currently under an EDP run significant current account deficits. It is however normal for catching-up countries to strongly invest and to finance a part of their investment through foreign direct investment (FDI) flows. Taking into account net foreign direct investment, it can be seen that most of the NMS do not have any major current account deficits, as net FDIs are substantial (see Table 2). The three Baltic States (Estonia, Latvia and Lithuania) run low government deficits and debts, but large current account deficits. This is

true also when net FDIs are taken into consideration. In the case of Latvia, the external account was in surplus in the early 1990's (12.7% in 1991) and deteriorated continuously since then. Current accounts show smaller deficits in the other NMS. Among the larger NMS, Hungary's situation is more fragile than Poland, where the current deficit is as high as net FDIs, Czech Republic is in an intermediate situation.

2. The rationale of the SGP framework for the NMS

2.1. The rationale behind the original rules

The SGP rules have been implemented in the context of 'old member states' joining a monetary union. The justification for the 3% of GDP rule remains unclear. Among the reasons often given, the 3% of GDP level would be the level that would stabilise debt to GDP ratios at 60%, for a country with a nominal growth of 5% a year.

Nominal growth is in fact well above 5% in most of the NMS (the exception being Malta). Considering averages for 2001-2007, as estimated in the latest European Commission Forecasts, nominal growth ranges from 5.7 in Poland to 13.0 in Latvia (see table 4). Let us consider the Czech Republic: the current government debt stands at 36% of GDP and with a nominal growth of 6.6%, a deficit of 2.4 % of GDP will stabilise the debt to GDP ratio at its current level. A deficit of 4% would be consistent with a stable debt ratio of 60% of GDP.

Only Hungary and Poland had a public deficit slightly above the level required to stabilize their debt at 60% of GDP in 2005.

Table 4

	Public balance, %GDP, 2005	Public debt, % GDP, 2005	Real GDP growth, % 2001-2007	GDP deflator, % 2001-2007	Nominal GDP growth, % 2001-2007	Deficit stabilising the debt ratio At current level	Deficit stabilising the debt ratio At 60%
Czech R.	-3.2	36.2	3.6	2.9	6.6	2.39	3.96
Estonia	1.1	5.1	7.3	3.7	11.3	0.58	6.78
Cyprus	-2.8	70.4	3.4	2.9	6.4	4.51	3.84
Latvia	-1.2	12.8	7.7	5.1	13.2	1.69	7.92
Lithuania	-2.0	20.7	7.2	1.7	9.0	1.86	5.40
Hungary	-6.1	57.2	3.7	5.6	9.5	5.43	5.70
Malta	-4.2	77.2	0.3	2.6	2.9	2.24	1.74
Poland	-3.6	46.3	3.4	2.2	5.7	2.64	3.42
Slovenia	-1.7	29.3	3.6	4.6	8.4	2.46	5.04
Slovakia	-4.1	36.7	5.0	3.7	8.9	3.27	5.34

Source: European Commission. own calculations

Another justification given for the 3% of GDP limit would be that it was the average level of public investment as a percentage of GDP in the OMS. But if this was applied to the NMS, then the limit for deficits would be closer to 5 than to 3%: so a higher limit would be more appropriate for the NMS

For those in favour of applying the Maastricht rules to the deficits, the justification is in fact of another kind: the deficit ceiling is seen as a tool enabling to lower the level of public spending in the NMS. It is a way to cut public consumption and social transfers deemed to be

inefficient and even to have a negative impact on growth. Public spending is considered to have anti-Keynesian effects. The argument is more in terms of reducing the size of the State in the economy. Governments run too high public spending for 'electoral' reasons, but this leads agents to anticipate future higher taxation and hence to lower their consumption and investment. So the implementation of the SGP is a way to reduce the level of public spending and would support growth in the medium-term. These anti-Keynesian views have become widespread in Europe, both among the academics, at the European Commission and at the ECB.

But what about the macroeconomic management in the US, where fiscal policy is still used in a Keynesian way and has in the economic slowdown initiated in 2000 played a strong part in boosting US GDP. Why would the situation be different in Europe?

The choice of the level of public expenditure must be left to the People of each country. The Commission has not right to interfere with this choice. The NMS currently have a level of public expenditure close to the level of the OMS (see Table 2). The European authorities should not encourage the NMS to move towards a liberal model (less public expenditure, privatisation of pension and of health insurance) which is not the model of the majority of OMS.

2.2. The NMS and the 2005 reform of the SGP[1]

The SGP rules have undergone a reform in March 2005, when the Commission and all Member States agreed on a text adopted by the Ecofin Council. The agreement accounted for the 'increased divergence in an enlarged Union'.

The SGP remains essential in the EMU macroeconomic framework, without the reasons why the Pact did not work being commented. The Council states that the economic rationale of budgetary rules must be enhanced but also that the 3% of GDP value for the deficit ratio and the 60% value for the debt ratio remain the centrepiece of multilateral surveillance.

Part II of the agreement, **'Strengthening the preventive arm'**, accepts to define medium term objectives (MTO) differentiated for each Member State. But the range goes only from -1% of GDP for low debt/high potential growth countries to balance or surplus for high debt/low potential growth countries. These limits have no economic rationale.

Hence NMS are required to have a MTO of -1% of GDP, which means for a country with nominal GDP growing by an annual 7%, to have a public debt of 14% of GDP, which is a very low level. Why not consider a deficit stabilising public debt at a reasonable level (i.e. an objective for the structural deficit of around 3.5% for a country with a nominal growth of 7%)?

The implicit liabilities from ageing populations will be taken into account. But why not consider the social contributions that people could pay to have a satisfying level of pension and health insurance? Countries with generous public pensions systems may well have a higher tax burden than countries where employees need to save on an individual basis in view of retirement or health spending.

Member States having not reached their MTO should make a budgetary effort of 0.5% of GDP per year (in cyclically adjusted and excluding one-off measures balances). The effort should be higher in positive output gap periods, smaller in bad times. But potential output and the economic cycle are difficult to assess.

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[1] This part is to a large extent based on Fritsche and al. (2005).

Structural reforms, in particular pension reforms introducing a mandatory, fully funded pillar, will be taken into account if they raise potential growth and induce long-term savings in the long run. The design of the Social Security system is a national choice and there is no justification for a European rule to provide incentives for a fully funded system.

Part III is entitled *'Improving the implementation of the excessive deficit procedure'*. The Commission will prepare a report if the deficit exceeds 3%. A small and temporary breaching of the rule will be allowed if it is due to negative growth or a strong negative output gap. The Commission report will take account of a number of factors such as: policies implemented in the framework of the Lisbon agenda, R&D spending, public investments, economic situation or debt sustainability. Member States will be able to put forward other factors like budgetary efforts for international solidarity, European goals or European unification. The cost of the introduction of a compulsory, fully funded pension pillar would also be taken into account. These elements may prevent to launch an EDP if the breaching of the deficit is limited and temporary. They could also allow for longer adjustment paths to bringing deficits below 3%.

On the one hand, the Commission keeps the right to prepare a report for each country breaching the ceiling and will be entitled to send directly an early warning. On the other hand, the state concerned will be entitled to justify its fiscal policy by output gaps, public investment, contribution to the EU budget or defence spending, or by the cost of Unification (for Germany) or other reasons... So the implementation of the EDP will not be automatic. It will require a specific judgement on the economic context and policy choices of the state concerned. How can peer countries condemn the policy run by an elected government, if this policy does not generate negative externalities for them?

The reform still lacks economic rationale: there is no reflection on the objective of fiscal policy. The medium term objective is not appropriate for the NMS. The 1% MTO for public deficits, the 60% threshold, the 0.5% of GDP requested budgetary efforts and more restrictive fiscal policies in good times mean that NMS governments will have to justify in permanence domestic fiscal developments before the Commission and peer countries.

3. The golden rule

Public investment, which will be used over several years, should be financed over a similar period of time. Independently of short-term stabilisation consideration, government budgets should be split into a current budget - including public capital stock depreciation related spending - which should be in balance and an investment budget, which would be financed through borrowing. Several economists (Modigliani *et al.*, 1998, Creel *et al.*, 2002, among others) have proposed to import this rule in the euro area: the structural current government balance, *i.e.* excluding public investment, should be permanently in balance or in surplus.

According to the golden rule, borrowing may finance public investment, which is important in particular for countries having significant investment needs. Buiter and Grafe (2003) highlight precisely the case of the new members of the EU. Under this rule, countries will not have to cut public investment to improve government borrowing. Lowering public investment is harmful in terms of potential output growth if endogenous growth theory has some relevance.

Balassone and Franco (2001) reject this rule in the name of the difficulties of measure. The rule implies that statisticians are able to estimate the cyclical part of government borrowing (therefore the output gap and its impact on public finances), public investment and public capital stock depreciation, in other words four questionable measures. But is not it better to

use a fair rule, estimated with a low degree of precision than to follow a wrong rule, estimated with precision?

A more fundamental criticism is that this rule defines the neutrality of fiscal policy, cyclical neutrality (only automatic stabilisers are allowed to work) and structural neutrality (public savings equals public investment). But a government may choose not to be neutral. It may wish to implement an expansionary fiscal policy in times of subdued activity or may wish to run a restrictive policy in a period a high inflation. It may wish to implement structural measures if it thinks that saving is too high *ex ante* (which would necessitate a too low interest rate) or too low (in the light of demographic changes). The proposed rule confuses a criterion of neutrality with a norm for economic policy. As with the existing rule, there is no certainty that the fiscal policy needed to reach a satisfying level of activity in a country not controlling the interest rate will match the golden rule.

Should a better than the current rule be proposed? Fiscal rules based on government balance will never account for the fact that public finances are only tools to support activity or to regulate the savings/investment equilibrium. Any proposal for a European fiscal rule, under the control of the Commission, neglects the fact that the surveillance of public finances in EMU should aim at avoiding that a country generates negative spill-over effects in partner countries rather than trying to define optimal national fiscal policies at the European level.

4. Designing an appropriate policy-mix for stability and growth

The monetary and fiscal framework needs to be redesigned in an enlarging euro area, accounting for the fact that there is a single monetary policy and national fiscal policies with increased heterogeneity among the Member States. In particular, the NMS will be growing more rapidly and with more rapid inflation than the OMS. The impact of the NMS will be limited at the EU level, due to the fact that they represent less than 5% of EU-25 GDP. But it is of first importance that fiscal rules are appropriately designed for catching-up countries, especially in terms of public investment. A more economically funded fiscal policy coordination has the advantage not to oblige NMS to undertake restrictive fiscal policies before entering the euro area.

Given the current level of European political integration, governments should keep their prerogative on national fiscal policy. The surveillance of economic policies should consist in avoiding that any national fiscal policy negatively affects the rest of the area (see Mathieu and Sterdyniak, 2004). That is why binding rules should bear directly on externalities. Thus, the rule should be that countries are allowed to implement the fiscal policy of their choice, as long as it does not affect the macroeconomic equilibrium of the area, in other words as long as domestic inflation stays in line with the inflation target of the area. For instance, with an inflation target set between 1.5% and 3.5% in the area, 'Northern' countries' could have a target within 1 and 3%, while catching-up countries would have a target between 2 and 5 %. With such rules, a country hit by a negative demand shock would be able to counterbalance it through an expansionary policy. Conversely, a country hit by a supply shock (inflationary pressures) would have to implement restrictive measures.

The European authorities – the Commission and the Ecofin Council of the euro area – would have the responsibility to check that inflation remains at the level set in each country, and possibly to accept some deviations and adjustment periods, in the event of specific or common shocks. The European authorities could also have the responsibility to check that

domestic public debts do not put public finance sustainability at risk, or that no country runs an excessively large current account deficit (net of FDI) relatively to the area current account balance. It is crucial that surveillance bears only on issues potentially generating negative externalities between countries in the monetary union.

So, fiscal policy in the euro area should be based on three pillars. Each country could take the golden rule for public finances as a Medium Term Objective. A surveillance funded on true negative externalities would oblige the Council and the Commission to link fiscal policies and macroeconomic unbalances, which is not currently the case. In addition, it would be desirable to set up real economic policy coordination in the framework of the Eurogroup, with whom the ECB would dialogue. This co-ordination should not focus on public finance balances, but should aim at supporting economic activity and achieving the 3% annual growth target of the Lisbon strategy.

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