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The Stability (and Growth) Pact and Monetary Policy

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The ECB and the Stability and Growth Pact

The ECB has a very clear idea of what European governments should do in the name of 'sound' economic management: balance the budget, reduce the role of the state in the economy by cutting public expenditures; increase the flexibility of labour markets by shrinking the welfare state (see for example the ECB's Monthly Bulletin April 2002), and increase competition in both product and labour markets. Structural reforms mean, in particular, reducing employment protection and the generosity of the system of unemployment benefits. It is expected that such a comprehensive policy framework will lead to an increase in work's incentives (lower taxes allowed by the decrease in public expenditure, and lower unemployment benefits), higher growth and lower inflation pressures (through the increase in the intensity of competition). This conception of the policy mix in a broad sense is fully mainstream, which is also fully normal, as nobody would expect that a central bank hold explicitly an heterodox position. It is thus utterly normal that the ECB take an active role in the budgetary debate, especially if this debate leans towards a possible reform of the SGP, which may be interpreted by the Bank as a reduction in the degree of cooperation from National States. The Stability and Growth Pact has indeed been designed also as an instrument to enforce the cooperation of European governments towards the aim of the ECB, namely price stability.

The ECB's vision would matter little if it did not have the power to 'punish' European governments reluctance to follow it by keeping interest rates at high levels. This is a very effective way of sanctioning national governments. The governments, on the other hand, have no power whatsoever to sanction the ECB and there is no procedure of accountability of the ECB before a parliament.[1] The Council of Ministers may well disagree with the ECB's monetary policy, but it has no way of forcing the ECB to change its behaviour. The ECB, on the other hand, can raise the economic and social costs for non-adherence of 'its' policy ideas. The only credible threat in the hands of governments is to reform the SGP.

There is usually what is known under the name of a game of chicken between the central banks and fiscal authorities which may be represented by the following dialogue:

[1] See JP. Fitoussi and J. Ceel: *How to reform The European Central Bank*, Centre for European reform, London, October 2002.

"I shall not lower interest rates because your are not doing enough to tighten your budget."
"But the economy of which I am in charge will go into recession!"
"Had you listened to me in the first place, you would now have enough room for manoeuvre to counter the slowdown."
"Had you cut rates more forcefully before, I would not have this problem now and I will not be discussing on a possible reform of the SGP.." Etc..

Despite this uncooperative game, I think it unlikely that the ECB will keep on delaying for too long a monetary move to punish member states because the SGP is being debated. What is at stake in the current debate is the degree of restrictivity of fiscal policy, not the possibility of an expansionary one.

Rules *and* discretion

The problem with rules is that they often reflect the economic and intellectual environment at the time they have been designed. Even when they have been intelligently conceived, their life expectancy is limited, which means that they have to be changed from time to time. The more rigid and the more context rooted they are, the more frequently they will have to be redesigned and of course the less credible they will be. That means that there is no way to throw discretion out of the picture. Either discretion will take the form of redesigning rules after a more or less short time span, or discretion will take the form of a flexible rule.
The Pact was designed assuming that governments would accumulate surpluses in good times to allow the operation of automatic stabilizers in bad times [2]. But it was signed at the end of a long phase of convergence to the Maastricht criteria, that involved procyclical fiscal policies during at least the years 1995-97. This in turn provoked, in the attempt to restore 'normal' levels of taxation and expenditure, expansionary policies when growth later resumed in Europe. That is, it begun to apply at a time where public deficits where rapidly vanishing reinforcing the belief that a situation of balanced budget would be easy to reach. The requirement of a balanced or in surplus budget was thus context dependant. For this reason the Euro area economy has experienced, especially since the end of the US expansion of the 1990s, an explosive combination of depressed growth and (procyclical) restrictive fiscal policy. Mainly because of high interest charges , the three largest countries, Germany France and Italy do not have room for the automatic stabilizers to play, so that fiscal policy is ineffective even facing transitory shocks. This situation being simply unbearable, it is already resulting in " creative accounting" experiments, and in increasing pressure to revise or soften the Pact. Even worse, the impossibility to use the fiscal instrument is inducing governments and economists to put pressure on the ECB for a more expansionary monetary stance, undermining the support for the fight against inflation.
Notice that if the SGP was limited to the 3% ceiling, the rule would have been much more flexible, its implementation being much less growth dependant. By and large, the 3% limit will, on average, be obeyed.
An other example of a context dependant "structural" policy choice is the inflation objective of the ECB of less than 2%. When the Bank begun its operations the rate of

[2] Nevertheless, "the problem, with the Pact as presently framed is that it is all stick and no carrot; rewarding good fiscal behaviour in booms rather than, or in addition to, punishing bad behaviour in slumps, would certainly make better sense" (Bean, 1998 p.106).

inflation was very low, about 1%, due to an abnormally low oil price and an abnormally high exchange rate of the euro. In this context, an inflation target of less than 2% seemed reasonable. But that means that a structural choice was deeply rooted in a very specific economic situation. Would the same objective have been chosen if the ECB entered into operation 2 years latter? I very much doubt of that.
The problem is that the choice of an inflation target has strong consequences on the conduct of budgetary policy. The more conservative it is, the more difficult it will be to reach the fiscal objective. Hence the ECB's choice, done after the signature of the stability pact, make it more difficult for governments to obey the pact. For example an inflation target of 1.5% instead of 2.5%, implies that a country with a debt to GDP ratio of 60%, should have a deficit lower of about 0.6% to stabilise this ratio, compared to a situation where the inflation target is 2.5%.

Reinterpreting the SGP

From the outset, I would like to say that I fully support the analysis contained in the working document *"On public finances in EMU-2002"* by Manuel Antonio dos Santos. It is true that the introduction of additional criteria to assess a country's fiscal policy will render more flexible the interpretation of the pact, and will increase the room of manoeuvre of National Governments. The reason is obvious: it allows to compromise between several objectives, the fiscal target being only one of them. For example a greater deficit may be allowed if the inflation rate is lower than average (and thus the real interest rate higher), and/or if the unemployment rate is too high (the level of employment too low). But that means only that we are taking into account the structural deficit. I will thus focus on three reform proposals, which amount to consider alternatively the level of debt, the structural deficit and public investment as additional criteria.

a) The criteria of debt seems to be robust and simple to apply: countries with high debt to GDP ratios should have a higher primary surplus. In fixing a common target for the euro area countries, the SGP is de facto taking care of it. But by requiring a medium run budgetary position close to balance or in surplus, the SGP is pushing towards a zero debt burden in the (very?) long run. Such a requirement is arbitrary, and choosing another criteria for the long run level of debt may be more feasible and acceptable. For example, if the long run level of debt is fixed at 60%, and a country is already at that level, a deficit of 3% on average will stabilise the level of the debt, on the realistic assumption of a nominal growth rate of 5%. Countries with a public debt in excess of 60% of GDP should have a lower, but still "positive" deficit during the transition period. A more conservative figure may be chosen for the "sustainable" level of debt, for example 40%. It suffice to say that such a criteria will still permit to countries like France and Germany to sustain a permanent deficit of about 2%. Hence a criteria of public debt will allow for more room of manoeuvre for governments. But such a criteria remains artificial as it is defined irrespectively of the productive assets that public debt has helped to finance. It is a gross figure instead of a net one. Two countries with an equal public debt to GDP ratio may be in a completely different situation with respect to their infrastructures and public services, for example.
The objective of a "zero debt" in the long run seems to be linked with the question of **ageing hidden liabilities**. Either it means that the decrease of the public debt to zero in the very long run is a substitute to reforming the pensions scheme; or it means

that the increase in contributions which is an unavoidable effect of the increase in life expectancy has to be matched by an equivalent decrease in other taxes. Whatever the interpretation, it implies that the provision of the public good "increase in life expectancy" has to be financed by a decrease in the provision of others public goods. There is nothing wrong with this, except that is a political decision which has to be discussed openly and not to be decided in an hidden way through a mechanical application of a budgetary rule.

b) Economists generally agree that the SGP's reliance on headline fiscal deficits is misguided and that it would be preferable to focus on **'structural' deficits** -- a definition of the deficit that strips out the impact of cyclical economic fluctuations on revenue and expenditure. Using headline deficits as a benchmark has a number of disadvantages. It forces governments to tighten fiscal policy exactly when growth is weak and thus limits or even prohibits the functioning of automatic fiscal stabilisers. Since current expenditure, such as public-sector wages or unemployment benefits, tend to be fixed in advance, government are often forced to slash public investment – the most flexible part of the budget – to cut the deficit. This can be seen as undesirable, especially during an economic downturn. This also implies that the SGP may be particularly detrimental for the EU's less developed member-states, which require high public investment to support their economic catch-up. However, clearer rules are needed if a modified SGP is to both reinforce the credibility of budgetary policy and reassure the ECB about inflationary risks. Buiter et al (1993) have long proposed to set a limit of 3 per cent for structural deficits, based on the fact that public investment spending typically represents around 3 per cent of a country's GDP and that it is normal and safe for this to be funded by borrowing.

c) Given the importance of **public investment** for growth, Europe's fiscal framework could be based on the 'golden rule' of public finances[3], which stipulates that over the medium term the current public deficit -- excluding investment spending -- should be zero. But just like the SGP, the golden rule may prevent the automatic stabilisers from operating. It is why the rule should require that the structural deficit excluding public investment is balanced over the medium term. Distinguishing current spending from public investment can be very tricky. In the European context, it would best be left to the Council, after consultation with the European parliament, to clarify the distinction with the advantage that by defining what can be classified as investment spending, the Council may even encourage governments to orientate their fiscal spending towards policy areas that have been highlighted as European priorities, such as trans-European transport links, research and development (R&D), higher education and new technologies. Much superior to current economic policy co-ordination, which is cumbersome and controversial, this modified rule may even help the emergence of a genuine set of European policies in those areas that are crucial for the future of Europe.

The modified rule would impose enough restrictions on national budgetary policies to calm ECB fears whilst at the same time giving European governments enough room of manoeuvre to react to unforeseen circumstances and to pursue policies adapted to national circumstances. It would give European countries a degree of

[3] Economists have been arguing for this rule for a long time, see for example Eisner, 1986; Modigliani, Fitoussi et al., 1998.

autonomy in deciding what percentage of their national revenue they wish to devote to public investment. No definition of sound public finance management would expect this percentage to be the same from country to country. The European Council, by defining what constitutes public investment, gains new powers to instil priority policy areas with new momentum. Although the new rule would not guarantee the stabilisation of public debt, it would ensure that any increase is based on rising public investment. Notice that this rule will be in agreement both with the endogenous growth doctrine – because the choice of investment will be motivated by the aim of increasing potential growth – and with new keynesian doctrine – because the timing of the implementation of this growth policy could be dependant of the business cycle.

For the European policy mix, this 'liberation' of fiscal policy would be a breath of fresh air. The constant pressure on the ECB to adopt a more active macro-economic management would cease once European governments are no longer constrained by the rigid rules that now characterise the SGP. In addition, increases in public debt, the inflationary effects of which the Bank so dreads, would be associated with investments likely to be profitable in the future and hence there would no longer be any reason to classify them as inflationary.

Concluding remarks

The latest arrangement hammered out between member States, namely a decrease of at least 0.5% per year of the structural deficit implies that fiscal policy will be restrictive regardless of the growth situation. A rule which is not state dependant is not a good rule, as it may lead to a procyclical fiscal policy in certain circumstances and to a countercyclical one in others. On top of that predetermining fiscal policies, quite independently of monetary policy is not a good strategy. What would happen if, contrary to expectation growth will not resume in 2003?

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