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Jacek Rostowski

The Stability and Growth Pact – Essential and Unfeasible

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CASE – Center for Social and Economic Research

12 Sienkiewicza, 00-944 Warsaw, Poland

tel.: (48 22) 622 66 27, 828 61 33, fax: (48 22) 828 60 69

e-mail: case@case.com.pl

<http://www.case.com.pl/>

Contents

1. The fundamental problem	6
2. Demand spillovers	7
3. The weaknesses of the SGP	8
4. Proposals to improve the pact	11
5. Entrenched national guarantees of debt sustainability as a requirement for monetary union membership	13
6. Conclusion: EMU is a “premature monetary union”	15
References	16

Jacek Rostowski

Jacek Rostowski is Professor of Economics at Central European University, Budapest, Senior Fellow at the CASE Foundation, Warsaw and an associate of the International Economics Programme at the Royal Institute for International Affairs, London. He has served as adviser to the Finance Ministry and the National Bank in Poland, and advised on the transition from communism in Latvia, Russia, Serbia and Ukraine.

Abstract

The arguments for fiscal as well as monetary rules in a monetary union aiming at low inflation, the main weaknesses in the Stability and Growth Pact, and proposals for its reform are reviewed. Our own proposal for reforming the SGP is put forward: a requirement for eurozone Member States to enact entrenched legislation which would forbid budgets that led to public debt exceeding a certain proportion of GDP. Countries which failed to enact such provisions or which rescinded them could not remain in the eurozone. This would solve the key “enforcibility problem” that the SGP faces, without centralizing fiscal power in the European Commission. However, effective reform proposals are unlikely to be politically acceptable, and the SGP is likely to continue to be a dead letter. This suggests that the EMU was implemented prematurely.

1. The fundamental problem

The most convincing justification for the Stability and Growth Pact (SGP) is the existence of a severe free rider problem in a monetary union with a number of large countries. Ever since it was discovered (probably by the Emperor Diocletian in the second century) that inflation can be used to reduce the government's debt burden, a "fatal nexus" has existed between government debt and governmental control over initially the mint, then the printing press and finally the central bank. Not only is it possible for a government that controls the creation of money to reduce its real debt burden by generating inflation, but this fact is known to money holders and affects their willingness to hold government created money. Negative effects on economic efficiency, savings, economic growth and even on so called seignorage (government revenue from the creation of money) follow from the "option to inflate" held by all governments.

A number of mechanisms have therefore been invented to try and eliminate (or at the least severely limit) this option. They include fixing the parity of the state issued currency to one which is not so issued (the gold standard, currency boards, unilateral dollarization or euroization) and establishing an independent central bank. One problem has nevertheless persisted: how binding will such constraints on a government's monetary behaviour be when it actually faces the choice between debt default and breaking or rewriting such self imposed rules? Recent experience in Argentina suggests that "monetary rules" may not be very binding in this situation, even if the final result in Argentina turned out to be *both* the breaking of the rules *and* government debt default.

The result has been growing interest in "fiscal rules" which are designed to prevent public debt from reaching a level at which it could become unserviceable, and might therefore present a temptation for government to inflate it away. Gordon Brown's self-imposed so-called "golden rule" is an example from Britain¹, while the Polish constitutional limit on public debt to 60% of GDP is another.

The problem of the link between fiscal and monetary prudence takes on an extra dimension in a monetary union which consists of a number of large independent fiscal jurisdictions. The Germans have always feared the following scenario: less monetarily and fiscally prudent countries would take advantage of the increased credibility and lower interest rates which a European monetary union would bring in order to increase their public debt to levels at which the monetary rules of the union would lose their credibility. In anticipation of the ensuing future inflation, interest rates would rise for all. In exporting German monetary credibility to all, the EMU would then end up by importing other members' lack of credibility to Germany.²

¹ By this fiscal deficits should be balanced over the economic cycle except to the extent to which they pay for net public investment.

² This may be part of the reasoning behind German opposition to unilateral euroization, although this is misplaced, as a unilaterally euroized country has no right to ECB support for its banking system and would be unable to generate euro inflation itself (see Bratkowski and Rostowski, 2002).

Nor is such a fear fanciful. Germany and other traditionally prudent countries such as Austria and the Netherlands are massively outvoted on the existing Governing Council of the ECB, and will be so even more after enlargement of EMU to the East.

An additional problem is that the ECB does have some responsibility for the stability of member states' banking systems.³ Given the high levels of government debt held by banks in many EMU member states, in the case of default by an EMU member government it could be legitimately argued that this responsibility requires intervention to save the banking system of the country concerned. Given the extremely limited capital resources of the European System of Central Banks⁴ such intervention could only take the form of generating inflation.⁵

There is also a further, deeper, problem. Whereas the ECB could allow small countries' governments to default on their public debt, the consequences of allowing a major state to default and its banking system to collapse could be massively depressive for the whole union. In the absence of a monetary union, such a situation could be avoided by the affected country inflating the problem away. Within the eurozone it can only be avoided by the ECB generating inflation in the whole monetary union.⁶

The special problem posed by the existence of a few large independent fiscal jurisdictions within a monetary union is highlighted by the absence of any federal level fiscal rules binding on individual states in the USA. This is partly the result of most states having state-level balanced budget rules. But it may also result from the fact that there are 50 states, with California (the largest) accounting for one eighth of the union's GDP (and about one sixteenth of government expenditure in the USA), as compared to the 30% weight of Germany within the eurozone.

Fiscal rules in a monetary union with a few large independent fiscal jurisdictions are therefore even more important for guaranteeing the long-term credibility of its monetary rules than they are in a unitary state.

2. Demand spillovers

There is little evidence for strong spill-over effects. Large econometric models have generated insignificant (or even negative) spill-over effects [Thygesen, 1998]. An exception was the very large increase in the German deficit post-unification, which had perceptible positive spill-over

³ By Art.3 of the ECB Statute, the European System of Central Banks (ESCB) to which the ECB is central, has the responsibility of promoting the smooth functioning of payments systems.

⁴ The ECB and the National Central Banks of the eurozone member states.

⁵ This is why Ivo and Lemmen [1999] propose that government debt within a MU should not be treated as having zero risk as it is under present Bank for International Settlements (BIS) guidelines. Such a move is justified by the formal unavailability of the inflation option within the eurozone. Moreover, setting limits on single government debt exposure by banks would encourage diversification of banking system assets, making banks less exposed to default by their home country government (although partly at the cost of making them more exposed to default by *other* eurozone governments).

⁶ I exclude the possibility of the ECB providing the affected banking system with liquidity, since the problem we are discussing is one of the solvency of the government concerned and therefore of the banking system of the country as well. Such a problem cannot be resolved by mere injections of liquidity.

effects on demand initially.⁷ However, it is unclear that an excessive deficit provision helps a monetary union to deal with this problem, whereas a centralisation on fiscal policy authority is unlikely to be politically acceptable. Thygesen suggests voluntary co-operation (as provided for by the Maastricht Treaty) as the least bad solution of the spill-over problem.

3. The weaknesses of the SGP

i. Excessive deficit procedure v. SGP. The eurozone's fiscal rules consist of two parts: (1) the excessive deficit provision and procedure and (2) the SGP proper. The excessive deficit and the procedures to deal with one are incorporated in the Maastricht Treaty and its protocols. An excessive deficit exists if *either* of two conditions exists: (1) an EU member's fiscal deficit exceeds the so-called reference value of 3% of GDP, or (2) its debt/GDP ratio exceeds 60%. All EU members are required to avoid excessive deficits (defined as above). EU members who belong to the eurozone can be punished on the basis of the so-called "excessive deficit procedure" if they exceed the reference values for the fiscal deficit *or* public debt and are found to have done so by the Council of Ministers. Punishment can amount to fines of up to 0.5% of GDP yearly for persistent offenders. This is a large amount of money, current gross contributions to the EU being slightly over 1% of GDP, and the net contributions of large net contributors such as Germany and Italy being 0.2% of GDP.

The SGP proper, on the other hand, consists of one political declaration by the European Council (of Heads of State and Government) and two regulations issued by the Council of Ministers.⁸ The Pact does two main things: (1) it introduces the new obligation for states to achieve medium-term budgetary positions close to balance or in surplus; and (2) tightens up the procedures for identifying and for punishing excessive deficits among states which have adopted the euro. Thus, the excessive deficit procedure is thus quite strongly legally anchored, and allows for heavy fines on delinquent Member States, while the SGP has a far less formal legal basis, and no procedure to punish a failure to comply with the objective of medium term balance.

ii. Deficit vs. Debt aspects. The effect of this greater legal and institutional weight given to the excessive deficit provision as compared to the SGP was compounded by the fact that the *fiscal deficit* requirement of the excessive deficit provision was treated with great seriousness, while its public debt/GDP requirement was largely ignored. As a result, primacy has been given to what is a short-term requirement (keeping the general government deficit below 3% of GDP) compared to

⁷ The subsequent increase in interest rates and ensuing fall in investment demand was a "pecuniary externality", i.e. one in which markets transmit the right signals from one country to another. European (and indeed world-wide) interest rates do (and should) increase in response to a large increase in demand for financing by a major government. In the absence of a monetary union a larger part of the adjustment would occur through an appreciation of the currency of the state concerned. In the presence of the monetary union more of it has to occur through an increase in interest rates throughout the union. However, such an increase is preferable to some other form of rationing, and may well be preferable to not allowing the deficit to occur in the first place.

⁸ The first made at the Amsterdam summit of 1997, the latter a few weeks later.

the medium-term requirement of achieving fiscal balance over the economic cycle and the long term requirement of limiting public debt to less than 60% of GDP.

As we have seen, it is excessive public debt that constitutes the real threat to the credibility of a currency union's monetary rules. Yet Italy, Belgium and Greece were allowed to join the eurozone with debt/GDP levels of over 100%. Furthermore, by focussing on the fiscal deficit aspect of the excessive deficit provision in the Maastricht criteria for eurozone accession, while keeping the SGP requirements legally weakly grounded and unsupported by effective sanctions, the EU created a situation in which the incentives for Member States were highly asymmetric. States had a strong incentive to bring their deficits below 3% in order to qualify for eurozone membership. But once this had been achieved in 1998, they had little incentive to continue to improve their fiscal positions in the relatively good years of 1999-2001, so as to satisfy the SGP medium-term objective, given the absence of sanctions for such behaviour.

iii. The alleged “stupidity” of the pact. Many of the SGP's problems stem from these “original sins”:

1. The fact that some countries failed to achieve *medium-term* fiscal balance in 1999-2001, meant that they had very little scope to allow automatic fiscal stabilizers to operate once conditions deteriorated in 2001-3, without coming up against the excessive deficit provision.
2. The fact that the fiscal deficit aspect of the excessive deficit provision was made paramount, instead of the public debt aspect, meant that a *longer term* approach, which would have allowed low debt countries to run larger deficits than those allowed by the Maastricht Treaty when they ran into bad economic times had to be ruled out.

Had either of these processes not occurred, we would not be talking today about a “stupid” and “inflexible” SGP.

We have already discussed the reasons for the weakness of the medium-term goal of fiscal balance. There were also reasons for emphasising deficit over debt in the excessive deficit provision:

1. The correct measurement of public debt is quite problematic. The measure chosen was *gross public sector financial* debt. Thus, a government with significant financial assets (e.g. in the form of loans to LDC borrowers in good standing) would be penalised. So would a state which undertook pension or health reforms which created “funded” systems of finance for these needs, as that would transform so-called “implicit” debt (which does not count under the Maastricht provision) into explicit debt which does.⁹
2. Had the excessive deficit provision successfully prevented deficits exceeding 3% of GDP, then it would likely have led to significant reductions in the debt/GDP ratio. The relationship between the deficit and the debt/GDP ratio is given by:

$$D/Y = g_y * B/Y \quad (1)$$

⁹ One valid reason for leniency to Belgium in spite of its high debt, was that it has high levels of funded provision for both pensions and health care.

Where D/Y is the fiscal deficit, g_y is the growth rate of nominal GDP and B/Y is the steady state public debt/GDP ratio.¹⁰ So that with the GDP deflator increasing at about 1.5% yearly and real GDP growth expected to be about 2% (giving nominal GDP growth of 3.5%), deficits on average of 2.5% would lead the debt/GDP ratio to converge on 71.4%. While this does not satisfy the excessive deficit provision, it is still a level which is unlikely to threaten government solvency.¹¹

3. However, the main reasons seem to have been political:
 - a. There was no political will to exclude Italy, Belgium and Greece from the eurozone.
 - b. There was an unwillingness to delay the launch of the EMU project until measurement problems had been resolved.
 - c. The European Commission seems to have thought that stressing the fiscal deficit and the goal of medium term fiscal balance in the SGP, when combined with “multilateral convergence and surveillance procedure”,¹² could form the basis for the Commission gaining a key role in determining union-wide fiscal policy. Emphasis on the debt aspect of the excessive deficit provision would have left more room for policy discretion in the hands of Member States, and thus undermined the hopes of the Commission.

iv. Lack of enforceability. However, the fundamental problem with the SGP is its lack of enforceability. Countries are not automatically declared in breach of the excessive deficit procedure. They can only be so declared by a vote of the Council of Finance Ministers, taken by qualified majority. In a situation in which several large and influential countries either have excessive deficits, or are close to having them, such a declaration is unobtainable, even though the country voted on is not allowed to participate in the voting.¹³

In fact enforceability has not been uniformly weak. Small countries have until now on the whole respected both the excessive deficit proviso and the medium term goal of fiscal balance (the only serious exception has been Portugal).

¹⁰ The derivation of the formula is straightforward. The yearly change in the public debt equals the deficit of the public sector, so that $\partial B/\partial t$ (the change in public debt) = D . Now $B = (B/Y) \cdot Y$. If we take the time derivative of B we get: $\partial B/\partial t = (B/Y)\partial Y/\partial t + Y\partial(B/Y)/\partial t$. After setting $D = \partial B/\partial t$ we get: $D = (B/Y)\partial Y/\partial t + Y\partial(B/Y)/\partial t$. Dividing by Y , we get: $D/Y = (B/Y)(\partial Y/\partial t)/Y + \partial(B/Y)/\partial t = g_y(B/Y) + \partial(B/Y)/\partial t$. Now in the steady state $\partial(B/Y)/\partial t = 0$, so we are left with: $D/Y = g_y(B/Y)$.

¹¹ The Maastricht Treaty limit on $B/Y < 0.6$ together with the deficit limit on $D/Y < 0.03$, therefore implies a nominal growth rate of 5%. Even with inflation at (rather than under) the 2% p.a. ceiling set by the ECB, this implies a real growth rate of 3% p.a., which is improbably high.

¹² The Commission develops Union-wide “broad economic guidelines” annually, and Member States are then required to develop “stability programmes” (for eurozone members) and “convergence programmes” (for non-eurozone members) which must be consistent with the BEGs.

¹³ In November 2003 France, Germany and Portugal were projecting excessive deficits for the fourth year running, and Italy was close to an excessive deficit.

Table 1. Small is Beautiful (1997-2002)

	Big Three	Small Eight	Spain	UK
Fiscal balance	-2.06	0.13	-1.29	0.46
Growth	1.93	3.95	3.55	2.57

Source: D.Gros [2004]

What we therefore have had so far is an “asymmetry of good behaviour”. The fact that Ireland was actually censured in 2002 by the Council of Ministers *for not increasing its surplus sufficiently* suggests that we have also been witnessing the likelihood of an “asymmetry of enforcement” (at least in the perceptions of the small countries themselves). However, with the refusal of the Council to punish France and Germany in November 2003, enforceability has presumably collapsed for all Member States, both large and small.

Whether this will lead to a sharp deterioration in fiscal performance among the small states is, however, unclear. Because of their size they can be allowed to default on their debt, with relatively limited impact on the eurozone economy as a whole. Knowing this, they may well fear sharply rising interest rates in the face of any large deterioration of their public debt position, and this may be sufficient in itself to dissuade them from lax fiscal policy. However, such responsible behaviour by small Member States would be only a limited consolation. It is after all the large states which can, by their fiscal irresponsibility, threaten the sustainability of the EMU’s monetary rules. Of course, France and Germany still have quite manageable public debt/GDP ratios, so there still is time to repair the breach in the SGP. The question is how that should best be done.

4. Proposals to improve the pact

A number of proposals for the re-engineering of the Pact have been made. Four main kinds of mechanism have been suggested.

i. Expenditure rules. Two main mechanisms have been proposed – “permanent balance” and the so-called “golden rule”. Permanent balance involves forecasting future tax revenues and government expenditures and calculating their present value. As long as the two are equal, there is no fundamental shortfall of revenues, even if there is a large deficit at any particular moment [Buiters and Grafe, 2002]. In particular, countries that expect to have high growth rates (and therefore much higher future revenues) can afford much higher deficits in the present. The idea is as well founded as its basic assumption – that the future can be forecast with confidence.

The second mechanism within this approach is the UK Treasury’s golden rule, by which net spending on public investment is not included in the calculation of the excessive deficit [H.M.Treasury, 1998]. The idea is that future generations, which will benefit from today’s public investment should contribute to it.¹⁴ However, it is unclear why expenditure on physical infrastructure should count as public investment, while education does not. Also, if high investment

¹⁴ Which is why amortization of past investment should be included in any excessive deficit.

is needed today because the current generation has under-invested (as is argued in the UK) then surely it is this generation (rather than future ones) that should pay for making up the backlog.¹⁵ Finally, the real issue is the relative contribution to the net present value of the future stream of welfare generated by future GDP of public investment (either tax or debt financed) compared to the contribution of money left in private hands (and either consumed or invested). It is very possible that the money would be better used left in private hands. Public over-investment is also a possibility.

ii. Allocation of deficit rights. This could be done either by the EU itself, or by a pseudo market mechanism. It is very unlikely that Member States would agree to give this power to the Commission, or that they could regularly agree on how to divide up the overall permitted deficit for the eurozone as a whole (which would be set jointly by the Commission and the Council of Ministers).¹⁶ Casella [2001] suggests that budget deficit permits should be tradeable among Member States (their total value would add up to a figure chosen each year at EU wide level). The key problem with this proposal is that the costs to the other members of the monetary union of a highly indebted large country increasing its deficit (and therefore its public debt) could be much greater than a slightly indebted small country doing so.¹⁷

iii. An Independent Fiscal Authority. Wyplosz [2002] has suggested the creation of independent Fiscal Policy Committees at national level in all eurozone member states. These would be to the macro-policy fiscal stance what independent central banks are to monetary policy. They would base their decision on the fiscal stance each year on the need to ensure long-term sustainability while minimising short-term GDP and price fluctuations. Even if politicians agreed to the de-politicisation of the fiscal stance, it is unclear how ministers of finance could vary expenditure and revenue so as to achieve the stance set by the FPC efficiently. One possibility would be for most of the short-term changes to be achieved through tax rate changes, with expenditure variations being much slower. A possible difficulty in this case might be a relatively low level of response of aggregate demand to what would be known to be transitory tax changes [European Commission, 2002]. However, the strength of the proposal is that it sharply reduces the power of national politicians over fiscal policy, while at the same time establishing a framework which is designed to ensure long-term fiscal sustainability.

iv. Making Debt Sustainability Central to the SGP. Pisani-Ferry [2002] suggests allowing countries whose public debt/GDP ratio is less than 50% to opt for a “debt sustainability pact” instead of the excessive deficit procedure. Countries which did so would be required to provide

¹⁵ This point was made by Dr. Bini-Smaghi at the Aspen European Dialogue conference, Venice 26-27 February 2004.

¹⁶ The proposal was originally made by Strauss-Khan in 1999 as a way of setting the maximum permitted deficit for the whole eurozone at 3% of GDP [Buti, Eijfinger and Franco, 2003]. Since different Member States would often be at different stages of the business cycle, this would allow many to have deficits far in excess of 3% and would sharply increase the average deficit of the whole eurozone.

¹⁷ A debt-weighted premium could be added bureaucratically to the price. Alternatively, one could rely on the low deficit members of the union charging a higher price to a high risk purchaser of deficit rights so as to protect themselves from the spill-over effects.

estimates of the future impact of current budgetary commitments (such as the pension debt implicit in PAYG systems). Like the previous one, the proposal puts the stress where it should be – on sustainability. Its weaknesses are enforceability and the fact that implicit debt calculations are very sensitive to assumptions.

5. Entrenched national guarantees of debt sustainability as a requirement for monetary union membership

The most important problems with fiscal rules in the EMU is their enforceability and their legitimacy. Legitimacy itself requires:

1. That the rules be seen to be necessary;
2. That the rules be enforced in an impartial and equal manner on all states in the eurozone.

As we have seen, rules aimed at maintaining the sustainability of public finances are relatively easy to justify, while the need to avoid spill-over effects on aggregate demand is far less clear. As long as the imposition of sanctions for breaches of the SGP remains a political decision in the hands of national governments, large states will be unlikely to be punished. Yet it is precisely these states that most need to be controlled if the monetary rules of the eurozone are to be protected.

There are two possible solutions to this conundrum: the first is to give far greater power in the fiscal sphere to the European Commission, which would be allowed both to issue warnings *and* to impose fines under the excessive deficit procedure. I find such a degree of centralization uncongenial and unlikely to be politically acceptable to Member States.¹⁸

The alternative is to require eurozone states to enact *domestic* fiscal rules, which would be entrenched (i.e. would require supermajorities to rescind) and which if rescinded, would lead to the countries concerned having to quit the eurozone. An interesting example of such rules is the Polish constitutional limit on the public debt/GDP ratio, which may not exceed 60%.¹⁹ It has the advantage of being both relevant (applies to debt sustainability) and enforceable. Countries that have adopted the euro could be required to enact a provision of this kind, so that budgets that caused the public debt/GDP ratio to exceed the limit would simply not have legal force.²⁰ The rules could be more detailed, setting out what was required of budgets in the case when the ratio exceeded lower thresholds of 50% and 55%, as is done in the Polish “Law on Public Finance”.²¹

Domestic fiscal rules cannot, by definition, be violated (a budget which violates such rules is simply not legal, and could not be enforced in domestic law). They can, however, be rescinded by

¹⁸ Buti et al. [2003] have the same view.

¹⁹ By being part of the constitution, it requires a two thirds majority in the lower house (Sejm) of the Polish parliament, together with a simple majority in the Senate, to overthrow it.

²⁰ This could present a problem in the case of the UK which does not have a written constitution or entrenched legislation.

²¹ This is an ordinary, un-entrenched, provision.

sufficient super-majorities.²² However, under my proposal, countries which rescinded these rules (and thus break the conditions of eurozone membership) would automatically be required to leave the eurozone.²³ This is presumably what would happen under present rules if a country broke the Maastricht Treaty's requirement that its central bank be independent.²⁴ Thus, by combining domestically entrenched fiscal rules (which simply *cannot* be legally broken) with the external anchor of their existence being a requirement for continued eurozone membership, we get fiscal rules that exhibit a very high degree of enforcement and yet do not centralise discretionary fiscal power at monetary union level.

Given the drastic nature of expulsion from the monetary union as a sanction for breaking the public debt/GDP limit, it would be useful (as in the Polish case) to have lower thresholds in the domestic fiscal rules, the passing of which would require remedial action before the ultimate limit is reached. At present, Poland's Law on Public Finance forbids any increase in the budget deficit once the ratio of public debt/GDP exceeds 50%, and any increase in the debt/GDP ratio once the 55% threshold has been passed. However, these rules are under stress, because the Miller government (October 2001 – May 2004) increased the deficit very fast (by some 4% of GDP since coming to power). This will probably result in the lowest threshold for remedial action (50%) not being effective, as public debt will jump directly from a planned 49% of GDP in 2003 to an actual 57-59% in 2005.²⁵ Thus, the Polish Law needs updating, so as to prevent a government "jumping" the lower thresholds on the growth of public debt in this way, and leaving its successor with the need to rein debt in drastically since it is right up against the constitutional 60% limit. Such a reform in the Polish case might consist in a requirement that deficits not exceed 3% if an even lower threshold of public debt/GDP (say 45%) is passed.

Leaving aside the requirements of domestic law, within a reformed EMU, countries that violate a suitably chosen lower debt threshold could also lose their right to vote on the General Council of the ECB and in the "eurogroup" of finance ministers (which decides on fiscal policy co-ordination). This would prevent such countries' representatives from voting in favour of inflationary policies that would help reduce their real debt burdens.²⁶

Expulsion from the eurozone would not necessarily mean that a country would be obliged to reintroduce its own national currency to replace the euro. Countries might decide to continue using the euro, but their central banks could no longer participate in its creation, in the setting of interest

²² Something which may yet happen in Poland.

²³ The new treaty (which would be needed for the implementation of this approach) would state categorically that countries which rescind the required legislation, automatically leave the eurozone.

²⁴ The Governor of its Central Bank would presumably be excluded from the ECB Council under such circumstances, and if the central bank began to credit the government or "parastatal agencies" the country would presumably be asked to leave the ESCB and the eurozone.

²⁵ The problem lies in the fact that if the deficit is higher than planned in year t , the debt/GDP ratio may be certified as higher than 50% only in March of the year after ($t+1$). In that case the ban on increasing the deficit (compared to that of year t) applies to year $t+2$.

²⁶ The present deposits and fines for eurozone members running an excessive deficit do not seem to be incentive compatible, as they make fulfilment of the Maastricht Treaty requirement even harder.

rates for the euro area, in seignorage revenue from euro creation²⁷ or in any implicit “lender of last resort” liquidity support which their banking systems might expect. They would then effectively be “unilaterally euroized”.²⁸ At the very least an extremely strong signal will have been sent to the markets that the country is not in the same “risk league” as eurozone members, and that the risk of government default depends exclusively on the condition of its own public finances. Re-admission to the eurozone after expulsion would be made conditional on reintroduction of the domestic fiscal rules required by the Treaty, and on bringing the public debt/GDP ratio down below the Treaty’s lower debt threshold.

There are, however, serious problems in implementing the proposal. The main one is that of “unequal starting points”. Italy and Greece (and to a lesser degree Belgium) have public debts that would be unacceptable if they obtained in the whole of the monetary union. We either have to accept that some countries are allowed to maintain higher public debts than others are allowed, or these debts must be reduced. A possible solution would be to give these countries a number of years derogation from the debt/GDP limit, during which time they would have to bring their ratios into line, or be automatically excluded from the union.

The second problem is implicit pension debt. Pension reforms which move a country to a system of “funded” pensions transform implicit pension debt into explicit government debt to the pension funds. Nearly every single country implementing such a reform would find that its public debt/GDP ratio would exceed 60% at the end of the transition.²⁹ A 60% limit will thus discourage the implementation of reforms, so a higher limit needs to be agreed for countries with funded pension systems.

But what should that limit be? And would a limit of say 200% or 250% of GDP (which would be required for many countries after pension reform) lead to a sustainable debt? The two kinds of debt (implicit and explicit) are not, after all, fully comparable. Explicit debt is “harder”. Governments cannot renege on it as easily as they might be able to reduce expected (or current) pensions in case of severe fiscal stress.

6. Conclusion: EMU is a “premature monetary union”

The EMU is a “premature monetary union”. It is premature in its overall structure (i.e the absence of an effective fiscal constitution – which it vitally needs), and also in the admission of countries that should not have been admitted given that their debt/GDP ratios were at levels that would not be safe for the union as a whole (Greece, Italy and maybe Belgium). It is also premature in the sense that the

²⁷ In the case of countries which are net contributors to the ECB (such as Germany) this could actually improve their financial position if the demand for euro money base growth was small or negative, and the net contribution to the ECB (which is the difference between earnings from assets backing the monetary liabilities of the national central bank concerned and the country’s share in total eurozone seignorage based equally on its share in eurozone GDP and population) was large.

²⁸ I am grateful to Marek Dąbrowski for drawing this point to my attention.

²⁹ With the possible exceptions of the UK and Ireland.

rules of admission to the union are not well designed, particularly as regards the choice of the exchange rate at which currencies will be converted into euros. One question flowing from this analysis is whether EMU can be repaired “on the go” (is it, figuratively, a ship or a plane?).

Second, given the political difficulty of enacting the reforms I have suggested, the usefulness of such proposals (and many of those made by other authors) may be doubted. However, EMU may not be the last monetary union to be created. There has been talk of an East Asian Monetary Union. So analysing the errors that have been made in setting up the EMU need not be a pointless task, even if EMU itself proves unreformable.

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