

# Should the European Stability and Growth Pact be Changed?

*Against the background of several EU members' difficulties in meeting the terms of the European Stability and Growth Pact, calls for reform, or indeed abandonment, of the Pact have become louder. Is the Pact in its present form economically harmful? If so, how could the rules be changed to make more economic sense?*

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## The Stability and Growth Pact Neglects the Policy Mix between Fiscal and Monetary Policy

The debate on the institutional design of European Monetary Union was characterised by a broad consensus among politicians and academics that "stringent rules" (Delors-Report) for national fiscal policies are a prerequisite for an efficient common monetary policy. This view shaped the Maastricht Treaty and it led to the Stability and Growth Pact (SGP). The current discussion on the SGP shows that the rules laid down in the SGP are assessed in a rather controversial way. The aim of this paper is a short evaluation of the SGP in the light of the experience of almost four years of EMU. It tries to find out whether the philosophy which underlies the SGP is supported by the facts and therefore whether policymakers in countries with high deficits should be advised to adhere to the SGP rules under all circumstances. This issue is of special importance in the context of the monetary dialogue with the European Central Bank, which is one of the most ardent supporters of a strict adherence to the SGP.<sup>1</sup>

It is well known that both the SGP and the criteria of convergence were not the result of an intensive academic debate. Especially the SGP can be clearly attributed to the situation in 1997 where additional safeguards were needed in order to mollify the strong fears of many Germans that EMU would lead to inflation. Accordingly the SGP is based on the philosophy that fiscal deficits are a main cause of inflation.

"The European Council underlines the importance of safeguarding sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation. It is also necessary to ensure that national budgetary policies support stability oriented monetary policies."<sup>2</sup>

After almost four years of EMU it is possible to as-

sess this core hypothesis. As Figure 1 shows, there is absolutely no evidence of a systematic correlation between the size of fiscal deficits and national inflation rates. If anything, the opposite seems to be true. This "anomaly" constitutes an important warning sign. If the underlying assumption of the SGP is flawed, it could be very dangerous to rely on its policy recommendations, especially in countries which are close to the 3 % threshold or even beyond.

The inherent problems of the SGP become obvious, if it is tried to solve the "puzzle" of high deficits and low inflation. A starting point is the more implicit assumption of the SGP that high deficits are caused by lax fiscal policies. A good test for this view is the correlation between the average real growth rate of government consumption and fiscal deficits during the EMU period. Again we are confronted with a somewhat surprising result (Figure 2). A low increase of real government consumption is on average associated with high deficits and vice versa. In other words, fiscal rectitude does not necessarily pay off.

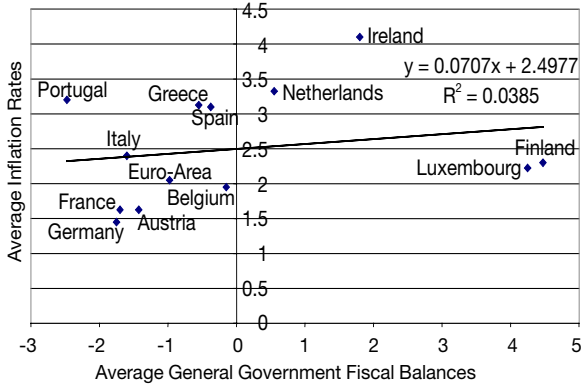
Thus, another explanation for the differing deficit performance of the EMU member countries is required. An obvious candidate are the growth rates of real GDP. As Figure 3 shows, there is a relatively strong correlation between average GDP growth and average fiscal balances in the 1999-2002 period. In other words: the deficit problems with which several member countries are confronted today were mainly caused by below average economic growth during the four years of EMU.

<sup>1</sup> E.g. in its October Bulletin (p.6) the ECB calls for "decisive action in order to set up credible adjustment paths" and it maintains "...adjustment paths must entail significant yearly improvements in the cyclically adjusted balance, to be followed strictly and completed within the shortest possible time frame."

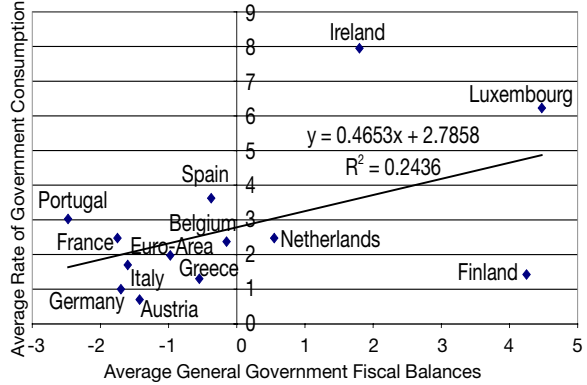
<sup>2</sup> Resolution of the European Council on the Stability and Growth Pact, Amsterdam European Council, 16 and 17 June 1997.

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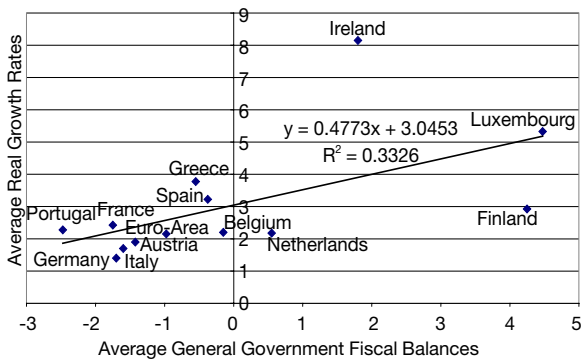
**Figure 1**  
**Inflation Rates and General Government Fiscal Balances (1999-2002)**



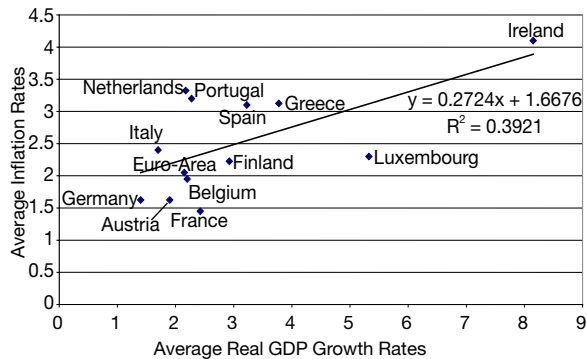
**Figure 2**  
**Real Government Consumption and General Government Fiscal Balances (1999-2002)**



**Figure 3**  
**Real GDP Growth and General Government Fiscal Balances (1999-2002)**



**Figure 4**  
**Real GDP Growth and Inflation Rates (1999-2002)**



One could be tempted to argue that a low growth performance is not a cause but a consequence of high deficits and thus a too strong government interference with market processes. However, in Germany, where the GDP growth rate has been lowest of all EMU countries, the relationship of government expenditure to GDP (48.6 %) is almost identical with the EMU average of 48.5 %. At the other end of the spectrum, Finland with government expenditure equalling 50.4 % of GDP has been able to achieve an annual GDP growth rate of 2.9 %, which is higher than the EMU average of 2.2 %.

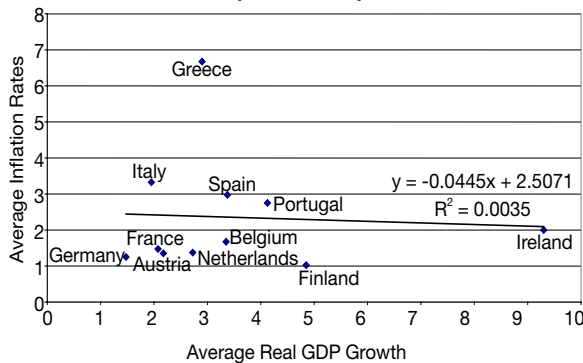
This leads to the question of other causes of the differences in real growth performance. Again a somewhat surprising finding can be presented. If average GDP growth and average inflation are plotted in a scatter diagram, a clear Phillips-curve relationship for the EMU period can be observed: a high national inflation rate goes hand in hand with high real growth (Figure 4).

This result can only partly be attributed to the

Balassa-Samuelson effect, according to which countries with high productivity growth exhibit high inflation rates. This becomes obvious if we look at the same relationship in the four years preceding EMU. In the period 1995-1998 no evidence can be found for a Phillips-curve relationship although growth differentials were also considerable (Figure 5).

What is then a possible link between relatively high inflation rates and an above average growth performance? The answer is simple. In a monetary union the central bank can only set a common nominal interest rate for all member countries. The real interest rate, which is decisive for investors and the savings decisions of households, is determined at the national level according to the domestic inflation rate and inflation expectations. In other words the differences in national inflation rates in Figure 5 are identical with differences in national short-term real interest rates. Thus, whenever there are idiosyncratic factors leading to above or below average GDP growth, EMU is confronted with the risk of destabilising processes:

**Figure 5**  
**Real GDP Growth and Inflation Rates**  
**(1995-1998)**



- In countries with a strong growth performance wage increases are relatively high. This leads to an above average inflation rate, and the real interest rate declines so that the economy obtains an additional stimulus. This process also improves the fiscal situation.
- In countries with a relatively weak growth performance, the increase in nominal wages and the inflation rate remain below the EMU average. As a result, the real interest rate is high and growth is additionally restricted. Due to low growth the fiscal position deteriorates over time.

A certain indication of a widening gap between high and low inflation countries is the fact that the inflation differential between EMU members has increased from 0.7 percentage points before EMU entry (1998) to 3.5 points in 2000 and it has remained at 3.2 in 2002.<sup>3</sup>

Thus, an adequate macroeconomic policy mix at the national level requires that national fiscal policy is flexible enough to provide the necessary compensation for overly restrictive or expansionary monetary policy conditions. Unfortunately, the founding fathers of the SGP were so occupied by the deficit-inflation nexus that they did not pay attention to this additional need for flexibility. Above all, they set the deficit threshold and the SGP escape clauses in too narrow a way, since they were derived from observations for the pre-EMU period, in which countries still had national monetary policy instruments (interest and exchange rate) at their disposal. While it is impossible in this short paper to define more adequate thresholds, one can at least say that it is dangerous if countries with “excessive deficits” and very low inflation rates are obliged to adhere to the SGP in a strict way. This calls for a procyclical fiscal policy stance so that fiscal policy – instead of compensating overly restrictive monetary conditions – could aggravate an existing imbalance by further reducing the national inflation rate.

Since fiscal policy rules are essential for the functioning of a monetary union, the analysis of this paper calls for a reform of the SGP. While the current framework with its focus on inflation is clearly too one-dimensional, it could be supplemented relatively easily with an additional dimension which takes care of the mix between the common monetary policy and national fiscal policies. Again, this paper can only give some general suggestions. Since the ECB has a very strong interest in preventing excessive inflation at the national level, it would be useful to base the assessment of fiscal policy on forecasts for the national rate and their compatibility with the ECB’s inflation target.

- As long as the majority of forecasts show that a country’s inflation rate will remain *within* the ECB’s target range of “below 2%”, it would be presumed that the overall policy mix of national fiscal policy and the national real interest rate was adequate. In this situation, a fiscal deficit exceeding the 3% threshold would not pose a problem for the common monetary policy. Of course, it would be necessary to make an additional assessment as to whether this fiscal policy stance could threaten the overall solidity of a country’s public finances. For example, in the present situation in Germany such a risk could clearly be excluded.
- If the majority of forecasts show an inflation rate that exceeds the ECB’s target range by a certain margin (e.g. one percentage point), it must be presumed that the policy mix is inadequate. If in this situation the deficit exceeds 3%, there is a strong indication that the national fiscal policy is not compatible with an adequate policy mix and an excessive deficit procedure would be warranted.
- If the forecasts show that the national rate will exceed the ECB’s inflation target by a wider margin (e.g. two percentage points), imposing sanctions for fiscal policy could be considered even if the deficit is below three per cent or even if it is in a much better position.

The main advantage of this inflation targeting framework, which would of course need much discussion in detail, is that it provides the flexibility that national fiscal policy needs in a monetary union in order to cope with idiosyncratic shocks. At the same time, it would set more stringent fiscal limits for high inflation countries than envisaged in the SGP.

In sum, the main flaw of the SGP is its neglect of the interplay of national fiscal policy *and* national

<sup>3</sup> It is important to note that the widening was not caused by a “traditional” inflation country like Italy but by the high growth countries like Ireland which had rather low inflation rates before EMU entry.

monetary conditions in a monetary union. Although, as the example of Portugal shows, an “excessive deficit” can be caused by fiscal laxness, it can also be due to a self-aggravating process of below average growth, subdued nominal wage increases, below average inflation and an above average real interest rate. Thus, the SGP’s one-dimensional focus on the deficit-inflation nexus can be totally misleading. A strict application of the SGP can have the consequence that a country is forced to abandon its only macroeconomic stabiliser and even to pursue a procyclical fiscal policy. The current attempt of the German government to reduce the structural deficit in a period of economic stagnation and increasing unemployment is a case in point. Together with above average real interest rates such a policy mix entails a high risk of deflation<sup>4</sup> and of a further widening of monetary conditions within EMU. As monetary policy would become very difficult under such conditions, the ECB should also have a strong interest in avoiding such risks.

Since fiscal policy rules are necessary in a monetary union, the SGP should be supplemented so that it sanctions fiscal policies only if a country’s overall macroeconomic policy stance is inflationary, i.e. if forecasts show that its inflation rate will exceed the ECB’s target rate by one or more percentage points. Such an “inflation targeting” approach would not only provide a better policy mix in countries with weak growth, since the 3% threshold would not be binding, but it would also improve the policy mix in above inflation countries since one could think of sanctions whenever the fiscal policy stance contributes to inflation beyond the ECB’s target range.

<sup>4</sup> The editorial in the ECB’s October Bulletin shows that the ECB is currently not fully aware of the risk with which some countries, especially Germany, are confronted. On page 6, the problem of a procyclical policy stance is downplayed as follows: “Credible fiscal consolidation is supportive to the outlook for economic growth. Direct effects on demand in the short term should be counteracted by higher credibility of the conduct of fiscal policy, boosting confidence and thus private spending.”

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## What To Do with the Stability Pact

Four years after the creation of the euro, the architects of Europe’s single currency are entitled to bask in a warm glow of success. The transfer of power from national central banks to the ECB went off without a hitch. In its first four years the ECB has met its prime objective of maintaining price stability while pursuing a broadly appropriate monetary policy. The introduction of the physical euro went more smoothly than anticipated by even the most dyed-in-the-wool europhile.

The benefits of all this are undeniable. While the last few years have seen the collapse of equity valuations, a series of corporate scandals, terrorist attacks on a major financial center, mounting geopolitical tensions, and balance-sheet problems for a growing number of European banks, there has been no monetary turmoil like that which had been characteristic of European financial markets in the 1980s and 1990s. Western Europe has experienced no currency crises like those of its earlier history, which would have surely recurred in the absence of the euro. There has been no implosion of European financial markets – to the contrary, recent years have witnessed an unprecedented expansion of the securities-market access of the small, sub-investment grade companies that are the engines of

growth in a modern, innovation-based economy. The last development – the growing depth and liquidity of Europe’s corporate bond market – is similarly attributable to the euro.

### Time to Rethink the Pact

Success breeds security, or at least it should. European policy makers should now feel secure enough to rethink their assumptions about the institutions of the euro area. Indeed, there are a number of signs that just such a rethink is already underway. The ECB Board has signaled a willingness to take a more flexible approach to the pursuit of its prime objective and to respond more quickly to changing macroeconomic conditions in the manner of the US Federal Reserve Board. It has indicated a readiness to accommodate the looming expansion of its membership by moving to a rotation system, in which all countries rotate on and off the policy-making council, something that would have been inconceivable as recently as three years ago. A rethink of the Stability and Growth Pact (SGP) should be next. Already the ECOFIN Council has revised its Code of Conduct on the content and presentation of the stability and convergence programs submitted in conjunction with the SGP, requiring the adoption of agreed assumptions regarding the main extra-EU variables and clarifying the meaning of the medium-term target of “close to balance or in sur-

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