

## The Euro and the Stability Pact

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This paper is an expansion of the talk that I gave at the Allied Social Sciences Association meeting on January 8, 2005. The first part of the paper presents that text which discusses the inherent conflict between the simultaneous existence of a single currency and the independent fiscal policies of the member countries of the European Economic and Monetary Union (EMU). I describe how that has led EMU governments to ignore the Stability Pact's constraint on budget deficits and how they are seeking to undermine it by changing the rules themselves. The final part of the paper, written at the end of March 2005, describes the actual resolution of the issue by the agreement reached at the end of March by the European Council. The new policy effectively abandons the Stability Pact and leaves the way open to much larger sustained deficits.

### The Single Currency and Independent Fiscal Policies

I want to talk today about the relation between the Euro and the much maligned Growth and Stability Pact. My basic point is a simple one: the European institutional structure with a centralized monetary policy but decentralized fiscal policies creates a very strong bias toward large chronic fiscal deficits and rising ratios of debt to GDP. An effective political agreement among the Eurozone countries is needed to prevent those deficits.

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The reason for this bias is that the existence of a single currency for the entire Eurozone means that excessive fiscal deficits in any individual country do not cause the rise in that nation's interest rates or the change in its exchange rate that would occur in a country with its own currency. In short, there is no market feedback to discipline large budget deficits.

But cumulative deficits are harmful, not only to the countries that incur them but also to the other countries in the EMU. The value of the Euro and of the long-term real interest rate in the EMU countries will respond eventually to the size of the fiscal deficit and of the national debt in the Eurozone as a whole. Large cumulative deficits may also lead to increased pressure on the European Central Bank to permit higher inflation as a way of eroding the real value of those obligations.

A country that increases its own budget deficit contributes to this Eurozone problem but does not bear any disproportionate share of the adverse effect. This free rider problem becomes increasingly important as the number of countries in the European Economic and Monetary Union (the EMU) increases. It is this fiscal externality that justifies an agreement among the countries to limit their deficits.

A chronic fiscal deficit may start as a temporary deficit in response to a cyclical weakness that continues on after the weakness ends and is never reversed. The pressure on national governments within the Eurozone to use fiscal policy to counter a cyclical downturn is very clear. Because of the single currency, the national governments cannot use monetary policy to offset temporary economic weakness. There can be only one monetary policy and essentially one level of interest rates for all of the Eurozone countries. So even the natural decline in interest rates that would normally occur in response to a weakness of domestic economic activity in a country with its own currency cannot happen to a Eurozone country. The same is true about the exchange rate.

Without either discretionary monetary policy or an automatic cyclical adjustment of interest rates or of the exchange rate, a country can stimulate aggregate demand only by fiscal policy. While a fiscal policy can in principle take the form of a revenue neutral change in fiscal incentives – e.g., an investment tax credit offset by a temporary rise in the corporate income tax rate – the usual fiscal response to an economic downturn is a tax cut that increases the budget deficit. Moreover, deficit-expanding fiscal policy has greater potency with the interest rate and exchange rate essentially fixed than it would if the country had its own currency.

There is also a greater need in Europe than in the United States to use discretionary fiscal policy to respond to an economic downturn in a “local” area – i.e., in a European country or an American state. This reflects both fundamental labor market differences between Europe and the US and differences between the two fiscal systems. By fundamental labor market differences I mean the much greater geographic mobility and wage flexibility in the US than in Europe. A sharp decline in demand for the products of Massachusetts, my own state, some years ago led to a relative decline in the Massachusetts labor force (more out-migration and less in-migration) and to a decline in the relative wage of Massachusetts workers. The European labor force is much less mobile (because of differences in language and culture and a general reluctance to move even within countries) and wages are much less flexible.

The contrast between the centralized fiscal system in the United States and the decentralized fiscal system in Europe is also very important in this context. A decline of economic activity in a single US state automatically causes a substantial decline in the flow of taxes to Washington from residents and businesses in that state and an increase in transfer payments from Washington. The magnitude is roughly

equal to 40 percent of the local decline in GDP. This net fiscal swing constitutes a significant external fiscal stimulus to the local economy. In contrast, with the decentralized European fiscal system, a fall of GDP in any country causes a contraction in tax revenue in that country but very little net transfer from outside.

In short, the combination of a centralized monetary policy and a decentralized fiscal structure in Europe increases the need for and the effectiveness of countercyclical fiscal policy. The problem arises when the resulting budget deficit is not reversed in a relatively short time.

But the temptation to have chronic budget deficits is more than just a political difficulty in reversing a cyclical policy. A budget deficit is a tempting way to finance additional spending in any economy. The reaction of financial markets to chronic deficits acts as a deterrent when countries have their own currencies in a way that no longer happens in the Euro area.

### Recent Fiscal Deficits

The current debate in Europe about modifying the Stability and Growth Pact shows how difficult it is to bring fiscal deficits under control. It was Germany that originally insisted that a rule limiting fiscal deficits to no more than 3 percent of GDP be made part of the Maastricht agreement. Nevertheless, by 2002, Germany and France were running deficits of more than 3 percent of GDP. In 2004, deficits rose to be more than 3.5 percent of GDP in France and Germany and reached more than 3 percent of GDP in Greece, Italy, the Netherlands and Portugal.

It was also agreed in the Stability and Growth Pact that countries should achieve fiscal balance over the cycle. No provision was made to allow deficits to increase beyond three percent during

recessions, as some now advocate. The requirement of fiscal balance over the cycle implied that the budget should be in surplus during normal years and that a deficit should be allowed during recessions, but not to exceed 3 percent of GDP. This limit on the maximum deficit was backed up by the prospect of huge fines, requiring national governments that violated the deficit condition to pay up to one-half percent of GDP. No such fines have actually been imposed.

Long term interest rates on the government bonds of the Eurozone countries do not reflect differences in budget deficits or in the relative size of government debt. The 10-year government bond rates at the end of 2004 were 3.72 percent in France, 3.71 percent in Germany, 3.88 percent in Italy and 3.76 percent in Spain — all essentially the same. Spain received no reward from the bond market for its low deficit (1.1 percent of GDP) or its low debt (less than half of Italy's debt to GDP ratio of 106 percent.) This is not surprising because there is no reason for markets to penalize individual countries for borrowing excessively. A single country apparently does not move up its own supply curve of funds. And although the treaty explicitly precludes a bailout of any country that cannot pay its debt, the market discounts completely either the possibility that a Eurozone country would be unable to pay or the unwillingness of other EMU countries to come to its rescue if that should occur.

Instead of imposing the fines called for in the treaty, the European Union's Council of Ministers voted to suspend enforcement. In a rather remarkable display of political wrangling, the European Commission (effectively the executive part of the EU governing apparatus) then brought a case in the European Court of Justice seeking to set aside the decision of the Council of Ministers. Perhaps not surprisingly, the European Court took the treaty obligation literally and said in July of last year that the Council of Ministers did not have the right to suspend enforcement. But, as of now, no penalty has

been paid and no one is expecting any penalty to be paid. So much for the treaty obligation.

There is now a kind of gentlemen's agreement among the Euro countries that the budget deficit limit will be redefined to focus on longer-term deficits rather than single years and on deficits that occur because of slow growth as well as outright recessions. In the same spirit, a country would be judged more favorably if its debt to GDP ratio is low and if it is making progress in dealing with its long-term pension obligation. Some kind of peer pressure is to replace formal rebukes and penalties. Exactly how this is all to be reconciled with an unambiguous treaty obligation is not clear.

There is now a flurry of activity in Europe about proposals to revise the way budget deficits are calculated. Germany, the largest contributor to the EU common budget, has proposed that contributions to the EU budget be excluded from government spending for the purpose of calculating fiscal deficits. France, with the largest European military spending as a share of GDP, has suggested that military spending not be counted. And Italy has proposed that government outlays for research and development be dropped. These proposals have been rejected by the new EU president, Jean-Claude Juncker, who says that he will develop a new approach to the problem sometime in the next few months.

### Rules That Could Work

It is clear that fiscal virtue cannot be left to national decisions in a system in which centralized monetary policy is combined with decentralized budget authority. But what kind of rules could actually work?

Defining a cyclically adjusted budget deficit in Europe is difficult because unemployment rates are chronically high. Governments are tempted to call those high unemployment rates evidence of

inadequate demand even though most experts believe they reflect structural problems. The clearest way to resolve the dispute about what is a cyclical deficit is to recognize a rise in the deficit as “cyclical” only when unemployment has temporarily increased. By that standard, a country that has a 10 percent unemployment rate and that has had a 10 percent rate for the past three years does not have a cyclically elevated unemployment rate and is not in a temporary downturn. The entire budget deficit is therefore “structural.” In contrast, a country in which the unemployment rate rises from a previously stable level of (say) 7 percent to 9 percent does have a cyclical budget deficit. If that principle is accepted, the magnitude of the shift in the allowable fiscal situation per percentage point of unemployment (i.e., the size of the cyclical component of the budget deficit), is a technical issue that can easily be solved.

Much more difficult is the question of what is to be included in receipts and outlays. A relatively easy part of that question is the treatment of one-time balance sheet transactions, including the sale of public sector assets or the assumption of private sector liabilities by the government in exchange for cash. Such transactions do not change the net “wealth” of the public sector and therefore are not on a par with taxes or with changes in program spending that do raise or lower the deficit and therefore the national debt. .

What is needed to make a fiscal agreement effective are widely agreed rules for dealing with such things as deficits and surpluses in state owned industries, in subnational governments, and in other quasi-public groups. One reason that this is so hard to do is that countries differ in their institutional arrangements. A common set of budget accounting principles, created and monitored by an independent entity – perhaps the European Central Bank – could deal with these issues as well as making certain that the numbers that are reported to Brussels are an honest picture of government deficits and borrowing.

The issue of limiting fiscal independence would not be such a pressing problem if the existence of a single currency did not create a bias to chronic budget deficits . But that is the current European situation.

### The March 2005 European Council Agreement

The uncertainty about the Stability and Growth Pact was resolved for now by the European Council, meeting in Brussels in late March of 2005. The heads of government issued an agreement entitled “Improving the Operation of the Stability and Growth Pact” that proclaimed that the basic rules would be retained: a maximum budget deficit of three percent of GDP and maximum debt to GDP ratio of 60 percent.

At the same time, the Council specified exceptions to the interpretation of these rules that made them effectively meaningless. First, instead of an annual limit on the deficit, a country that is facing economic problems now has five years from the time that it breaches the deficit ceiling to get back under it. Moreover, a country can legitimately exceed the three percent ceiling (and presumably the 60 percent debt limit) if the spending that causes that violation is deemed to aim to “achieve European policy goals” or “foster international solidarity.” The agreement made clear that this could include spending on education, research, defense, financial aid as well as unspecified things that might contribute to European unity.

It is clear from this list and from the rejection of the attempt by EU President Jean-Claude Juncker to impose tighter controls that the Stability and Growth Pact no longer restricts fiscal deficits. The Economist , in its March 26<sup>th</sup> edition, concluded that the “rules have been so loosed

that they have been rendered almost entirely meaningless.”

Not surprisingly, the central banks were very critical. Mervyn King, Governor of the Bank of England, said that the European central bank governors were “dismayed” by the decision. The European Central Bank said they were “seriously concerned.” Standard and Poors warned that French government bonds would be downgraded to “junk” status within 20 years if current deficit and debt trends continue.

So there is no longer any restraint on individual country deficits. Already five of the 12 euro area countries have deficits that exceed the 3 percent ceiling, with Greece topping 6 percent.

And yet the bond market has still shown no tendency to punish those with high deficits or to reward those with low deficits and national debt. The range of 10 year government bonds rates among France, Germany and Spain was still only 4 basis points.

The danger looking forward is that each country will find ways to rationalize growing fiscal deficits, comfortable in the knowledge that there will be no formal pressure from other EMU countries and that the interest rate effects will be the same for all EMU countries. The European Council has done nothing to reconcile the independent fiscal decision making with the single currency.

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