Centre for European Policy Studies

CEPS Policy Brief

No. 58/ November 2004

The Dog that Lost Its Bark

The Commission and the Stability Pact

Daniel Gros, Thomas Mayer and Angel Ubide*

Thinking ahead for Europe

When large numbers of drivers begin ignoring the speed limit, it is good practice to revisit the original rationale and, if reaffirmed, to tighten enforcement, especially if the frequency of accidents increases. Hence, the EU Commission was right in launching a debate about the Stability and Growth Pact (SGP), which has been violated by an increasing number of EMU member countries. Unfortunately, however, the Commission's proposals for reform risk watering down the Pact, resulting in an erosion of fiscal discipline. In our view, countries presently struggling with excessive deficits should implement reinforced fiscal adjustment programmes. The case for a consolidation of government finances against the background of present and prospective demographic changes remains very strong.

The longer-term outlook for the European economy and SGP reform

The SGP was created in order to operationalise the general prohibition of 'excessive' deficits in the Maastricht Treaty. The Treaty, which introduced the constraints on fiscal policy, started from the assumption that nominal GDP would grow at 5% per year on trend and that a debt ratio of 60% of GDP was bearable. Consistent with these assumptions, it stipulated that government budget deficits must not exceed 3% of GDP.

In hindsight, this deficit limit appears rather generous. Reflecting the ECB's inflation target of less than 2% and real potential growth of probably only around 1¾% in Euroland, a more realistic assumption for Euroland's nominal trend growth is around 3½%. To stabilise the debt ratio at 60% of GDP, the deficit would have to be capped at 2.1%.

Moreover, ageing of the Euroland population raises government liabilities not included in the debt ratio in the Maastricht definition. Hence, to keep governments solvent, the latter should decline over time, ensuring that total government liabilities do not increase on trend over the next half century. These facts are generally accepted. Nevertheless, neither they nor their obvious implication that the conditions in the SGP should be tightened rather than loosened are reflected in the Commission's Communication of 3 September 2004.

Surprisingly, the Commission also seems to have ignored a key argument in favour of raising the threshold for invoking exceptional circumstances. With the potential growth rate having declined in most euro area countries, it is much more likely that countries will experience phases during which growth is 'low' by historical standards. Hence, when potential growth is slowing, authorities need to continuously update their view about what is exceptionally 'sluggish' growth. For example, a growth rate of 1.5% would most likely be considered 'sluggish' by politicians when compared to the goal of 3% as agreed at the Lisbon summit. However, growth of 1.5% might already be very close to (and for some countries above) potential growth in reality, and thus not qualify as 'sluggish'.

The Commission paper in detail

In its Communication of 3 September 2004, the Commission proposed a number of reforms with the stated aim to strengthen the SGP, an aim we would support given our view that the SGP remains necessary. The Commission proposal addresses six main points:

1. Prolonged periods of sluggish growth, which are to qualify as an "exceptional circumstance" where deficits of more than 3% of GDP are allowed

Contents

* Members of the CEPS Macroeconomic Policy Group and respectively, CEPS, Deutsche Bank and Tudor Investment Corporation. This briefing paper was originally prepared for submission to the Monetary Committee of the European Parliament. Unless otherwise indicated, the views expressed are attributable only to the authors in a personal capacity and not to any institution with which they are associated.

2. Country-specific elements in the enforcement and correction of excessive deficits
3. Country-specific elements in the definition of medium-term deficit objectives
4. Earlier actions to correct inadequate budgetary developments
5. Better links between general economic policy surveillance, fiscal policy surveillance, and national budgetary processes
6. Improved enforcement through ‘early warnings’ directly issued by the Commission; better fiscal statistics; greater peer pressure; greater transparency and accountability of the member states’ budgetary policies; and closer involvement of national parliaments in fiscal policy coordination

EU Finance Ministers, who will decide about any formal changes to the SGP early next year, are likely to welcome the first three points of the Commission’s proposal for reform, because they allow them to rebalance the mix of discretion and rules embedded in the Pact in favour of the former. In our view, however, this is likely to result in a watering down of the SGP since governments will always find excuses for an excessive deficit.

At first glance, allowing a period of sluggish growth to qualify as an 'exceptional circumstance' (granting an exception from the 3% deficit limit) seems to recognise that the accumulated output gap over several years matters more for government finances than that of a single period. The output gap could be larger after a long period of positive growth below potential than after a short recession. However, a reduction in potential growth is often recognised only after several years of weak growth. At the beginning of a period of lower growth, it is difficult to decide whether this is temporary or permanent. The temptation to regard it as temporary will be impossible to resist when this has the implication that higher deficits are allowed.

Moreover, even on a purely technical basis, the experience of 2003 shows that output gap estimates are subject to large revisions as new data come in. For example, when the very low growth rate for 2003 was put in the Commission’s model for the German potential growth rate, the estimate of the output gap had to be revised downward substantially, with the consequence that the estimate of the cyclically adjusted deficit increased by almost 0.5% of GDP. Hence, points 1-2 of the Commission’s proposal appear to allow necessary adjustment to be delayed and hence create the risk of a sizeable accumulation of excessive deficits and debt.

More generally, quantifying potential growth is an extremely difficult technical judgment which leaves much room for disagreement even among experts, as one can see by looking at the differences in estimates of potential growth coming from such respected institutions as the OECD, the IMF and the ECB. If estimates of potential growth rates acquire immediate political importance, it will be extremely difficult to shield the staff of the Commission from political pressure or to impede the Council to just come up with higher estimates. Therefore, the need for potential GDP growth estimates in the implementation of the SGP should be minimised (although it cannot be entirely eliminated), and estimates should be carried out, if at all possible, by an independent institution.

Points 4-6 pf the Commission communication may find more widespread support. However, the budgetary surveillance procedures proposed by the Commission lack teeth. History shows that the EU has never been able to pressure countries to consolidate government finances during good times. Hence, there is the serious risk that mostly lip service will be paid to this part of the Commission’s proposals without much tangible action.

Nevertheless, one thing may change. After the revelation that Greece has been able to systematically underreport its deficit for a number of years, it has become obvious that the capacity of the Commission to scrutinise and evaluate fiscal policy in member countries must be reinforced. As documented in a special report of the CEPS Macroeconomic Policy Group, entitled *The Nine Lives of the Stability Pact* and published in January 2004, the Commission cannot really supervise fiscal policy when it has only one full-time official per member country on average working in this area. Manpower is scarcer for the smaller than the larger member countries. Hence, it is not surprising that in the case of Portugal, and more recently Greece, the Commission was not able to discover large discrepancies in reported deficits. The capacity of the Commission to check national data, both ex post and ex ante, and the budget plans for the current year, must be strengthened.

These data problems – together with the monitoring problems resulting from the very large budget forecasting errors, as we also documented in our earlier report – bolster the case for the establishment of independent national budget agencies. These agencies would improve monitoring and provide alternative forecasts as a reality check on optimistic government assumptions.

Policy conclusions

The SGP was designed so that countries would be able to let automatic stabilisers work fully. For that, countries were required to achieve as soon as possible the desired starting point, namely a budget close to balance or in small surplus. The design of the SGP would then allow countries to weather cyclical fluctuations while respecting the 3% limit. This background is important for understanding the SGP fiasco, and it is essential to understand why the situation now is even worse than it was at the beginning of EMU. Why did some countries breach the 3% limit? Because they did not meet the commitment to achieve a budget position close to balance or in small surplus before the cyclical downturn of 2001-03. Thus, the SGP parameters were no longer adequate. But the failure was due to domestic fiscal policy decisions, not to the SGP parameters.

Today the situation is the even worse. There are two groups of countries: those which have the required budgetary starting condition of close to balance or small surplus, and those which do not. Any SGP re-parameterisation is going to fail for the countries that do not meet the initial requirement. If the European fiscal policy framework is to regain any credibility, it must ensure that the 'sinners' behave better this time. Peer pressure for greater fiscal discipline has proven ineffective. Hence, the sinners must be required to publish detailed plans how they intend to achieve the desired initial budgetary conditions as soon as feasible. They must demonstrate ownership of these plans by investing political capital in them, for example by committing before their own parliaments to a rigorous three-year plan approved by the Commission and to report back any deviation before their parliaments. This procedure is a model used by the IMF for programmes that have gone off-track: in this case, the authorities must make additional efforts to put the programme back on track.

Current prospects are not very encouraging: the French plan to reduce the budget deficit to 2.9% in 2005 is almost entirely dependent on a transfer of 0.5% of GDP from the energy utilities in return for assuming pension liabilities. Not only does this worsen the long-term fiscal outlook, but it is a reminder of how France only managed to meet the Maastricht criteria via another one-off transfer – that time from France Telecom. Fiscal adjustment plans for Germany and Italy presently also lack the necessary rigor to achieve lasting reductions in deficits.

If the sinners do not make the extra effort, the SGP will become an empty shell. When a country defaults on its debt, markets typically require an extra risk premium for its debt. The countries that 'defaulted' on their commitment the first time must now pay an extra price to restore their credibility. Markets do not impose discipline in Euroland – at least not now. However, the prospect of a sudden awakening of markets to the lack of EU fiscal discipline should never be ruled out. The 'sinning' countries must therefore provide additional collateral this time.

For the virtuous countries, discipline should be focused on not letting the cyclically-adjusted balance deteriorate, in order to prevent growth masking a deterioration of the underlying fiscal stance. It is maintenance work, rather than repair, but it is still needed. It is up to the Eurogroup to decide. But this may be the last chance to take forceful action against the sinners before the demographic shock starts hitting and debt levels start to accelerate.

Related CEPS Publications
(available from the CEPS bookshop at http://shop.ceps.be)

The European Productivity Slowdown: Causes and Implications, Daniel Gros and Jorgen Mortensen, CEPS Policy Brief No. 54, July 2004

*Economic Policy Coordination in EMU: What role for the SGP?***,** Jørgen Mortensen, CEPS Working Document No. 202, June 2004

Breaking the Reform Deadlock, 6th Annual Report of the CEPS Macroeconomic Policy Group, Daniel Gros, Thomas Mayer and Angel Ubide, July 2004

The Nine Lives of the Stability Pact, Special Report of the CEPS Macroeconomic Policy Group, Daniel Gros, Thomas Mayer and Angel Ubide, February 2004

Adjusting to Leaner Times, 5th Annual Report of the CEPS Macroeconomic Policy Group, Daniel Gros, Juan F. Jimeno, Thomas Mayer, Niels Thygesen and Angel Ubide, July 2003

The Euro at 25, Special Report of the CEPS Macroeconomic Policy Group, Daniel Gros, Massimiliano Castelli, Juan Jimeno, Thomas Mayer and Niels Thygesen, December 2002

Fiscal and Monetary Policy for a Low-Speed Europe, 4th Annual Report of the CEPS Macroeconomic Policy Group, Daniel Gros (ed.), June 2002

Testing the Speed Limit for Europe, 3rd Macroeconomic Policy Group Report, Daniel Gros, Juan F. Jimeno, Carlo Monticelli,, Guido Tabellini and Niels Thygesen, June 2001

Quo vadis euro? The Cost of Muddling Through, 2nd Report of the CEPS Macroeconomic Policy Group, Daniel Gros, Olivier Davanne, Michael Emerson, Thomas Mayer, Guido Tabellini and Niels Thygesen, May 2000

Macroeconomic Policy in the First Year of Euroland, 1st Annual Report of the CEPS Macroeconomic Policy Group, Daniel Gros, Olivier Blanchard, Michael Emerson, Thomas Mayer, Gilles Saint-Paul, Hans-Werner Sinn, Guido Tabellini, January 1999

Bookshop: http://shop.ceps.be

Website: www.ceps.be

About CEPS

Founded in 1983, the Centre for European Policy Studies is an independent policy research institute dedicated to producing sound policy research leading to constructive solutions to the challenges facing Europe today. Funding is obtained from membership fees, contributions from official institutions (European Commission, other international and multilateral institutions, and national bodies), foundation grants, project research, conferences fees and publication sales.

Goals

- To achieve high standards of academic excellence and maintain unqualified independence.
- To provide a forum for discussion among all stakeholders in the European policy process.
- To build collaborative networks of researchers, policy-makers and business across the whole of Europe.
- To disseminate our findings and views through a regular flow of publications and public events.

Assets and Achievements

- Complete independence to set its own priorities and freedom from any outside influence.
- Authoritative research by an international staff with a demonstrated capability to analyse policy questions and anticipate trends well before they become topics of general public discussion.
- Formation of seven different research networks, comprising some 140 research institutes from throughout Europe and beyond, to complement and consolidate our research expertise and to greatly extend our reach in a wide range of areas from agricultural and security policy to climate change, JHA and economic analysis.
- An extensive network of external collaborators, including some 35 senior associates with extensive working experience in EU affairs.

Programme Structure

CEPS is a place where creative and authoritative specialists reflect and comment on the problems and opportunities facing Europe today. This is evidenced by the depth and originality of its publications and the talent and prescience of its expanding research staff. The CEPS research programme is organised under two major headings:

Economic Policy
Macroeconomic Policy
European Network of Economic Policy
    Research Institutes (ENEPRI)
Financial Markets, Company Law & Taxation
European Credit Research Institute (ECRI)
Trade Developments & Policy
Energy, Environment & Climate Change
Agricultural Policy

Politics, Institutions and Security
The Future of Europe
Justice and Home Affairs
The Wider Europe
    South East Europe
    Caucasus & Black Sea
    EU-Russian/Ukraine Relations
    Mediterranean & Middle East
CEPS-IISS European Security Forum

In addition to these two sets of research programmes, the Centre organises a variety of activities within the CEPS Policy Forum. These include CEPS task forces, lunchtime membership meetings, network meetings abroad, board-level briefings for CEPS corporate members, conferences, training seminars, major annual events (e.g. the CEPS International Conference) and internet and media relations.

CENTRE FOR EUROPEAN POLICY STUDIES

Place du Congrès 1 • B-1000 Brussels
Tel: (32.2) 229.39.11 • Fax: (32.2) 219.41.51
www.ceps.be • info@ceps.be