Submission to the European Economic Committee of the House of Lords on the *Stability and Growth Pact*

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1. Relying on legislation rather than electorates to keep governments wise is not a recipe for long-term success. Gramm-Rudman in the United States did not prevent governments running huge deficits and the Euro zone's *Stability and Growth Pact* (SGP) is looking increasingly likely to become a casualty of a recession mixed with political pressures. The requirement that fiscal policy be put on a sound footing for membership of monetary union, when tied to the credible threat of exclusion for non-compliance, was successful in the 1990s. However, today, without the presence of credible penalties or sound intellectual reasons for compliance, the SGP has lost its teeth. Under these circumstances it comes as no surprise that the President of the EU Commission is unhappy left trying to enforce a set of rules that do not have a clear logic. It is damaging the Commission's credibility, without any prospective pay-off in terms of improved future economic performance.

2. While EMU was seen as having broadly favourable economic consequences by its founder members, the creation of the EMU changed the operating environment for all member economies by creating new channels through which the actions of individual members states could adversely affect the citizens of other members. It is this possibility of negative externalities for the union from fiscal policy in individual members (or a group of members) that required the addition of new rules for coordinating fiscal policy, leading to the agreement on the SGP. This need for additional co-ordination only applies to the members of the EMU; the UK as a non-member lacks the same potential to cause collateral damage to members of the EMU through imprudent domestic fiscal policy.

Need for Co-ordination Under EMU

3. There are three main channels through which economic policy in regional economies of the EMU can potentially cause collateral damage to other members:

   - Problems with the security of the banking system in one region could potentially affect all member states.

   - In spite of the no bail-out agreement, potential debt default in one regional economy could add to the risk premium payable by all other member governments, seriously raising the cost of capital.

   - Inappropriate stimulation by fiscal policy in a region[1] (or regions) of the EMU, by adding to inflationary pressures, could cause the ECB to raise interest rates, penalising those economies that had pursued sensible policies.

[1] Here individual national members are considered as regions of the EMU.

4. The SGP does not address the first of these possibilities, targeting instead the last two through its commitment to budgetary balance over the cycle and a limit on borrowing of 3% of GDP. Two questions must be asked about the SGP:

    - Is it effective in tackling the increased dangers from unwise fiscal policy action that arise from the creation of the monetary union?

    - Does it respect the principle of subsidiarity in requiring no more co-ordination of fiscal policy than is necessary to tackle these two dangers?

Financial Stability

5. All the members of the euro area have a clear interest in the stability of regional financial systems within the zone. Instability in one region could easily translate into a problem for all members. However, the supervision of the regional financial systems remains a national prerogative.

6. With the integration of the EU economy there may be a need to extend co-ordination of policy in this area. Certainly the creation of a monetary union enhances the risk that a regional financial collapse could have ramifications throughout the monetary union. The example of the BCCI débacle in the UK shows the difficulties in supervising banking systems in a global environment. Globalisation may require further co-ordination of banking supervision to ensure that problems in multinational financial enterprises do not go undetected.

7. It is not clear how far the ECB would feel required to intervene in the case of a regional financial collapse, such as occurred in Scandinavia in the late 1980s. Within a monetary union the scope for action by the national central banks is curtailed. This leaves uncertainty as to the assignment of responsibility, which could lead to difficulties, especially if a regional financial collapse was initially felt not to endanger the financial system of the union as a whole. The SGP does not deal with this potential problem.

Danger of Default

8. The current SGP involves rules covering both the debt-GDP ratio and borrowing as a percentage of GDP. However, if the only concern were the possibility of a government becoming insolvent, then the borrowing criterion is redundant. Pisani-Ferry, 2002, argues that if solvency were the only concern, the rules of the SGP should be amended so that if a country's debt-GDP ratio were below a certain specified level (e.g. 60%), a country should not be required to maintain a balanced budget over the cycle.[2] However, because it is written into the treaty, the 3% limit on borrowing would still apply for legal reasons, even if not for economic reasons.

9. Such a rule would certainly protect members of the EMU from the danger of any individual country becoming insolvent. It would also meet the subsidiarity criterion by allowing individual countries that meet the debt criterion considerable scope to

[2] He also suggests a requirement to maintain stricter accounting standards to ensure transparency.

choose their own fiscal policy stance. However, it would not deal with the danger that an inflationary fiscal policy pursued by one or a number of members of the union would impact unfavourably on other member states pursuing a non-inflationary policy.

10. This proposal still leaves a problem in choosing the appropriate debt-GDP ratio below which countries would be free to choose. The appropriate debt-GDP ratio for individual countries is likely to show considerable variation and a "one size fits all policy", while having the attraction of being simple, is unlikely to be optimal from the point of view of maximising the utility of individual countries, or of the union as a whole. There is already considerable variation in the demographic profiles of the member states of the union, and the prospect of enlargement, with many additional countries eventually joining the EMU, makes the adoption of a single rule on the appropriate debt-GDP ratio sub-optimal. In particular, where countries have a major deficit in public infrastructure, or where the demographic profile is particularly favourable, it is possible that higher levels of borrowing may be optimal.

11. In Germany, France, and Italy in the 1960s and the 1970s the investment to GDP ratio was close to 25% whereas today it is around 20%. This is reflected in the fact that public investment in infrastructure was also significantly higher than today. If these countries had been constrained from borrowing to fund infrastructural investment in the 1960s and the 1970s it could well have adversely affected their long-term growth potential. In the case of the current cohesion countries in the EU, investment rates are running significantly higher than in the other EU members. This reflects the infrastructural deficits that exist in these countries. A severe constraint on public borrowing in these countries, and in the new accession countries, could also slow their rate of convergence in living standards.

12. This concern that necessary public sector investment in infrastructure should not be constrained by too tight a limit on borrowing underlies the UK government's "golden rule": borrowing should only be undertaken to fund capital investment. However, experience elsewhere (Ireland in the 1970s and Japan in the 1990s) indicates that such a rule is open to abuse through inappropriate classification of public expenditure to get round the constraint on borrowing. It also takes no account of depreciation of the existing stock of public infrastructure.

13. In a recent paper, Blanchard and Giavazzi, 2002, propose that instead of a golden rule, countries should be allowed to borrow to fund net public investment (net of depreciation) and they propose institutional safeguards that might provide some protection against abuse. This variant of the "golden rule" is more logical from an economic point of view in that the cost of capital consumption (depreciation) is a charge on current taxation. However, like the "golden rule" it would not constrain countries from undertaking necessary and desirable infrastructural investment. If such a rule were followed, in the long run public sector debt would equal the stock of public infrastructure.

14. Any such rules would probably also have to include an upper bound on the debt-GDP ratio to ensure that the union is protected from the dangers of an individual country becoming insolvent. Such insolvency could occur if, for example, there was over-investment in unproductive infrastructure. It would also have to include the 3% deficit rule unless and until such a rule was removed through an amendment to the treaty

establishing the EMU. The removal of the 3% limit, while desirable, might be difficult to achieve, possibly involving a further referendum in certain member states.

Danger of Inflation

15. In co-ordinating the overall stance of fiscal policy in a national economy in a monetary union it is not necessary, or appropriate, to specify the mix of taxation and expenditure to be pursued in individual countries. What is important is the overall fiscal stance – the change in the cyclically adjusted deficit or surplus. (The latest Commission proposals recognise this, though identification of the cyclical element in deficits may be part art and part science.) It is this change in government saving that represents the ultimate impact on demand in the euro area. Even if individual countries are to be constrained to follow a particular path in terms of the change in their government savings (deficit), they still have autonomy in determining what mix of expenditure and taxation they will use.

16. If fiscal policy at the level of the euro area is appropriate (not putting pressure on interest rates through creating inflationary pressures), then independent action by an individual regional economy does not adversely affect other members. However, if a fiscal stimulus in one country contributes to an inappropriate fiscal stance at the level of the euro area, there is the possibility that it will require a tightening of monetary policy, with negative consequences for all other EMU members. This potential negative externality is the second important reason for co-ordination of fiscal policies (Butti and Martinot, 2000). Outside the euro area this need for co-ordination would not arise because changes in demand in a country outside EMU would not have any direct effect on interest rates in the euro area.[3]

17. The example of German unification highlights the possible gains to be obtained from effective fiscal policy co-ordination at the level of the euro area. In 1990 the huge infrastructural deficit that existed in the Eastern Länder of the newly unified Germany posed major problems for its government. However, a decision was made that taxes would not be raised to cover the full costs of unification, and government borrowing grew rapidly. This provided a very strong demand stimulus to the German economy. This stimulus was further accentuated by the decision to convert East German savings into deutschmarks at par. The consequence of the stimulatory fiscal policy pursued in Germany was that the Bundesbank had to tighten German monetary policy to offset the inflationary impact of the demand stimulus. However, the rise in interest rates in Germany was transmitted to all the other members of the ERM. Given the nature of the ERM this meant that there were serious negative externalities for the rest of the EU from procyclical German fiscal policy (Gagnon, Masson and McKibbin, 1996 and Barrell, Pain and Hurst, 1996).

[3] Co-ordinated fiscal policy action does not entail a harmonisation of tax or welfare rates across regional economies. A harmonisation of prices (including taxes and welfare rates) would prevent the normal adjustment processes necessary to promote convergence. Such differences are essential to ensure optimal use of resources within the euro area. However, there may be cases where discriminatory fiscal action may adversely affect other EU members but this will not be confined just to members of the euro area. It is also not an issue for the short-term management of the euro area economy and, as a result, it is not an issue to be considered in the guidelines for fiscal policy.

18. If EMU had begun in 1990, with effective co-ordination of fiscal policy, it is likely that fiscal policy in Germany would have been much tighter than was actually the case in the early 1990s. The result would have been that the EU would have escaped the major rise in interest rates that actually occurred. Gagnon, Masson and McKibbin (1996) and Barrell, Pain and Hurst (1996), estimate that the cost of inappropriate fiscal policy in Germany in the early 1990s was a loss in GDP of 2 to 3 percentage points in the UK, France and other EU members (other than Germany). While the increased demand from Germany resulted in increased exports from other EU members, this beneficial effect was more than offset by the negative effects of higher interest rates.

19. This is a very clear example where co-ordination of fiscal policy within an EMU could have been beneficial to the union as a whole (as well as probably saving the German economy from some of its current difficulties). If there had been a monetary union in 1990 Germany would have had to take into account the wider impact of its fiscal policy stance. In turn this would have required higher taxation or lower current expenditure in Germany to pay for unification, but the consequence would have been much lower interest rates and higher growth elsewhere in the monetary union.

20. For the future, disruptive fiscal policy action in large members of EMU, or disruptive action by a combination of smaller members of EMU, could potentially impose significant economic costs on all member states. Under these circumstances it remains desirable that the EU Commission has the power to co-ordinate fiscal policy within the euro area. However, it is an empirical question whether this potential danger of inflationary pressures arising from inappropriate fiscal policy action in any one member state (or a combination of member states) is likely to occur.

21. A study by Gros and Hobza, 2001, using the EU model QUEST and the UK National Institute model NiGEM suggests that the dangers of such inflationary shocks from inappropriate fiscal policy are much less likely under EMU than under the old EMS. This is because the effects from a fiscal stimulus in one country on the Euro area inflation will be much smaller than on the inflation rate of the country undertaking the stimulus. Because the ECB targets the Euro area inflation rate, and is not charged with responsibility for regional inflation rates, its response would be very limited.

22. If these results prove to be robust, they suggest that the concerns about an inappropriate inflationary fiscal policy in an individual Euro area member (or even group of members) causing a substantial rise in interest rates are exaggerated. It would require a very big shock across more than one large member state before such a rise would be realised. The implication of this research is that the SGP is probably too concerned with the issue of the short-term fiscal stance of member states of the EMU.

Conclusions

23. The SGP as it stands is not firmly grounded in economic logic, making it an ineffective instrument for achieving the necessary co-ordination of fiscal policy within the Euro area. However, it is probably not the best time to change it radically, just when it is coming under political pressure due to unwise fiscal policies pursued in a number of member states. Change might be better undertaken once the current problems are resolved, ensuring that the credibility of having wiser rules in the future is not fatally damaged by a clear lack of political commitment. In the medium term it

seems sensible to seek a reform of the SGP within the existing treaties, even if this means that some unsatisfactory provisions of the SGP are left in place.

24. The reforms should respect the principle of subsidiarity: the regulations should leave maximum powers to individual countries in the field of fiscal policy, subject to the need to ensure that unwise action by individual countries does not harm the interests of the EMU.

25. As a measure of fiscal stance it seems preferable on economic grounds to use the cyclically adjusted deficit rather than the actual deficit. However, the difficulties in defining such a deficit this may pose practical problems in implementation.

26. To prevent national governments becoming insolvent it is necessary to have a restriction on the level of debt relative to GDP. Pisani-Ferry suggests, if the debt-GDP ratio for an individual country lies above the specified threshold (e.g. 60%) then it is necessary to have a borrowing rule to ensure that the country follows a sustainable path for fiscal policy bringing it within that threshold. Below that threshold supervision by the Commission is not necessary. The Blanchard-Giavazzi rule (a modified version of the UK "Golden Rule") allowing borrowing to fund net investment in public infrastructure seems a sensible rule for governments to follow in any event, and it would ensure that in the very long run the public debt was equal to the stock of public infrastructure. Unless there is a change in the Treaties this borrowing would still have to be less than 3% of GDP.

27. Co-ordination of fiscal policies to avoid inflationary pressure arising from a fiscal stimulus is probably less important than is commonly supposed. The occasions when action will be necessary to achieve such co-ordination will probably arise infrequently in the future. At no time since EMU began has this been a problem. While the fiscal policies of a number of members states are likely to breach the requirements of the SGP this year, there is no suggestion that these policies are currently causing inflationary pressures within the EMU. For the future, where inflationary pressures are present due to the combined fiscal stance of the EMU, it is probably wise to reserve the power to the Commission to require the member states pursuing the most stimulatory fiscal policy to mend their ways.

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