Towards an Intelligent Stability and Growth Pact

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Introduction

- The current recession makes clear that the EU has failed to develop an institutional environment allowing for short-run and medium run macroeconomic management
- This failure exists both at the level of
  - Monetary policy
  - Budgetary policy
- I will concentrate on the failure of budgetary policies

- Recent events show that Stability and Growth Pact (SGP) is unworkable
- Despite attempts to ressuscitate it, it will also prove to be unworkable in the future
- In this talk I analyze why the SGP will never work
- I also outline how a workable SGP should look like

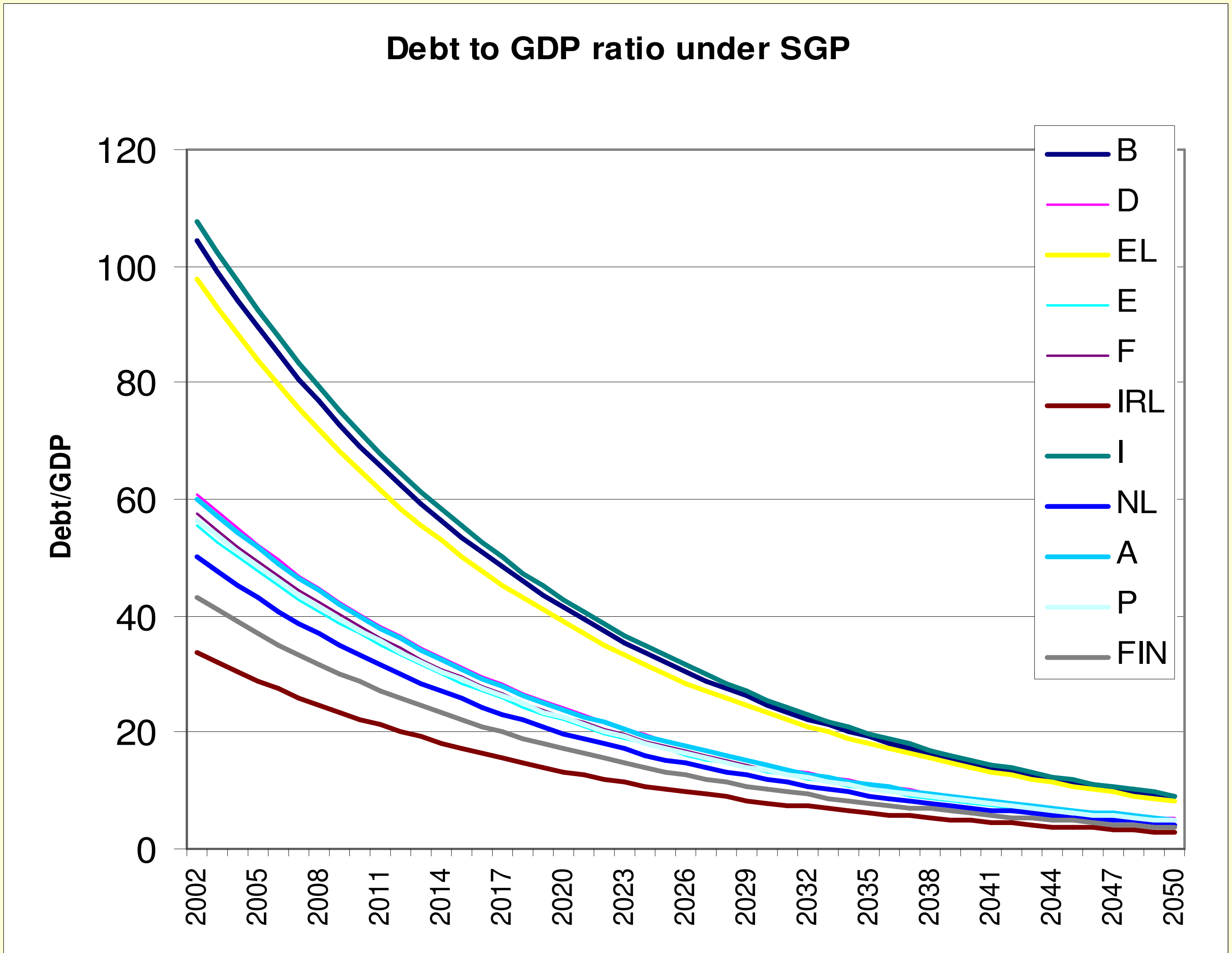
Long-term objective of the SGP

- SGP was motivated by the right concern, i.e. budgetary policies should be such as to lead to sustainable government debt levels
- Failure to maintain sustainable debt levels in the different member countries of the Eurozone endangers monetary and financial stability of the zone

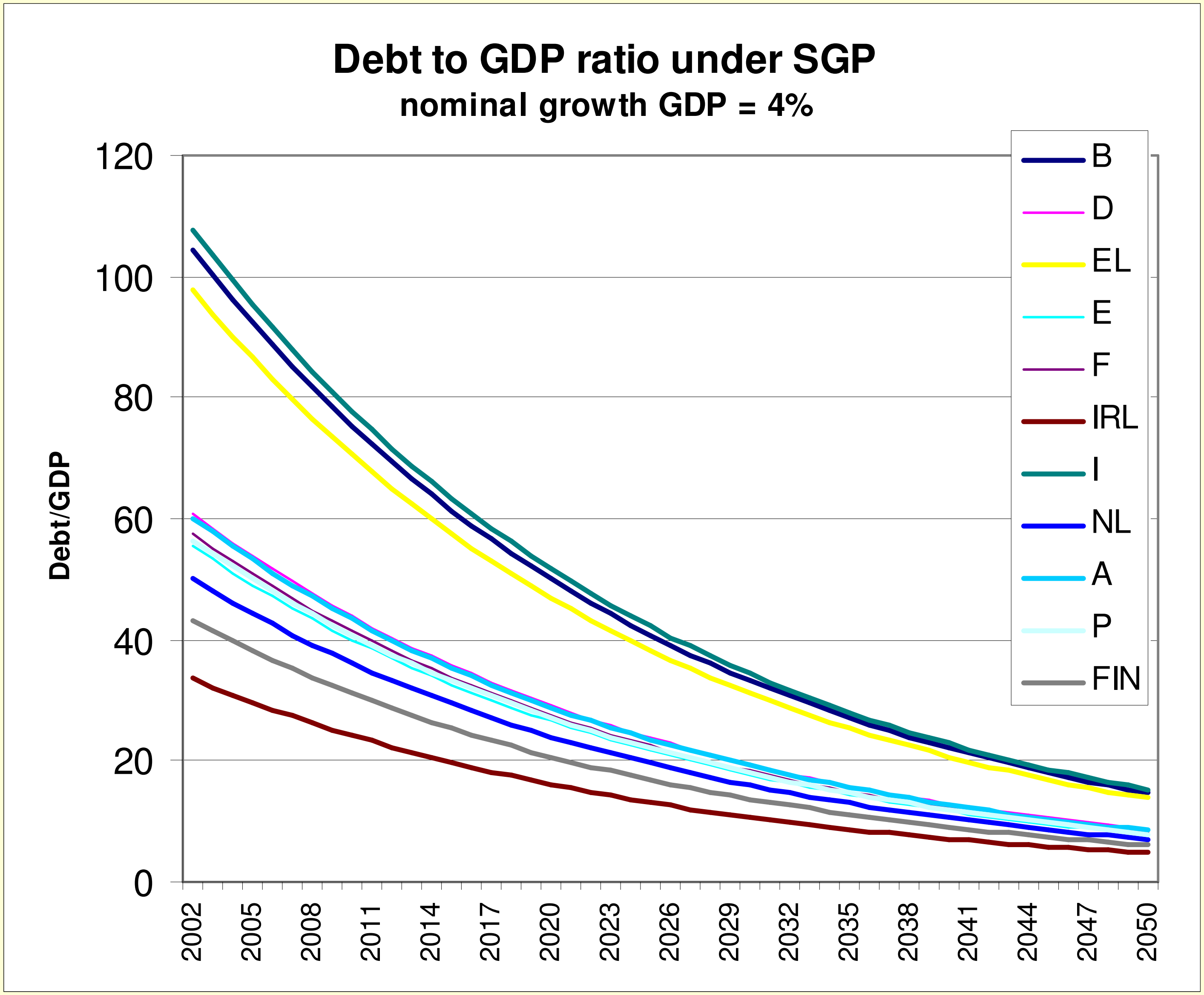
- Maastricht Treaty had given a practical meaning to sustainability:
  - sustainable debt level is 60% of GDP.
  - corresponding budget deficit consistent with this target debt ratio was put at 3% of GDP.
  - Condition: the nominal growth of GDP should be 5%

- Things have changed since the Maastricht Treaty
- Stability Pact introduced idea that governments should balance the budget over the medium run
- Implication: the steady state debt ratio that countries should aim at was lowered from 60% to 0%.
- A formidable change in objectives, that went almost unnoticed at the time the stability pact was agreed upon.

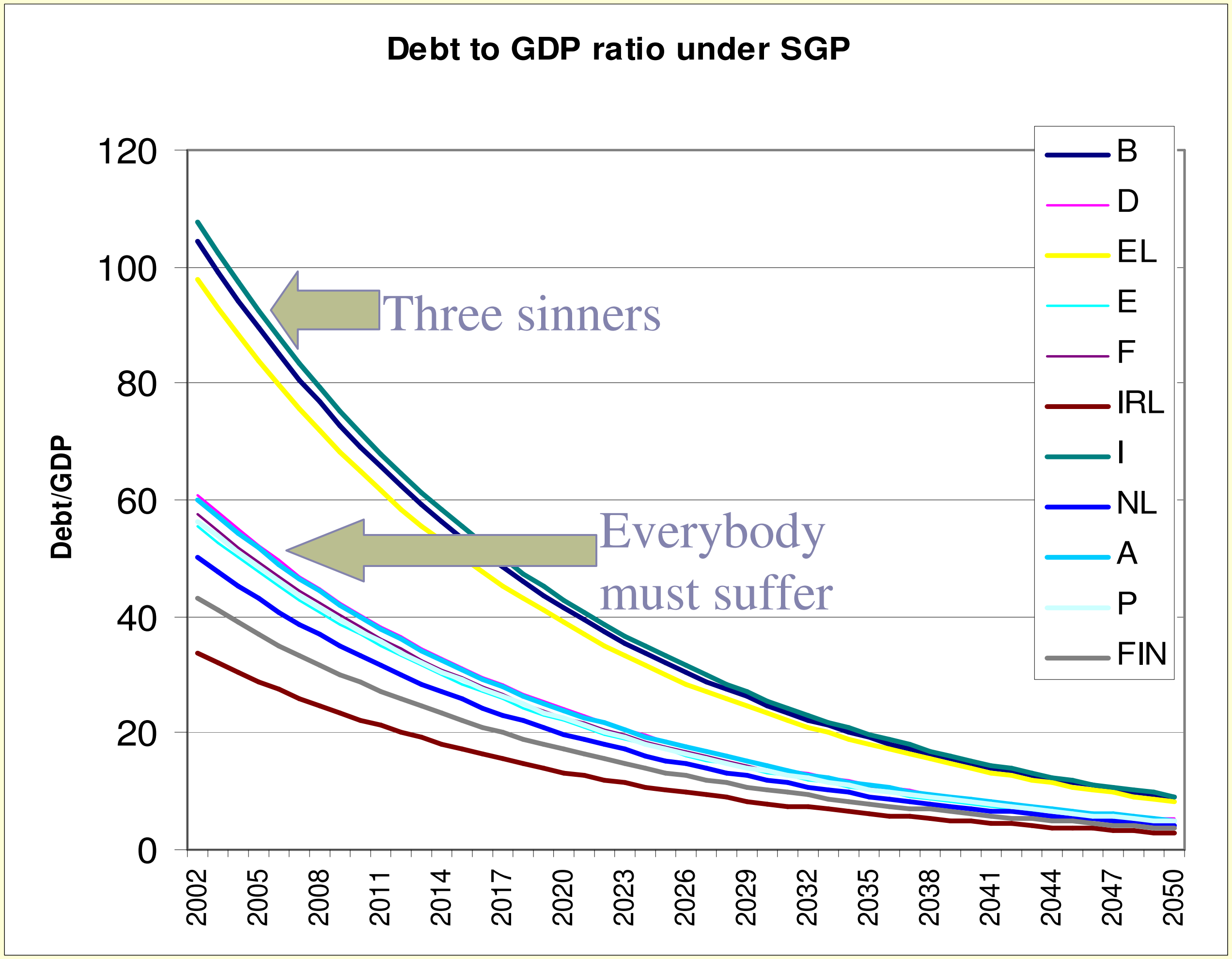
Hypothetical evolution of the debt ratios within Euroland assuming that the member countries abide by the pact, and assuming that nominal GDP increases by 5% a year.



Same message if we assume lower nominal growth of GDP



Why was the SGP introduced?



It was introduced to solve the problem of the three highly indebted countries

It made sense for these three countries as a temporary strategy

The problem is that it was forced on everybody as a permanent strategy

This makes as much sense as forbidding all firms to issue debt because some have issued too much debt.

Stability pact has no economic basis

- Requirement to bring the debt ratio to zero gives strong political incentives to reduce government investment:
  - governments are required to finance all new investments by current taxation,
  - a large part of benefits of these investments will be reaped by future governments,
  - This gives incentive to governments today to reduce these investments and only spend on items that benefit the present voters.
  - Thus the GSP is likely to lead to lower government investments and thus lower growth.

- SGP also forces many countries who do not need it to raise taxes. Most of it will be taxes on the immobile labour factor.
- This will further undermine the productive basis and bring us farther away from the Lisbon objectives

The stability pact is politically unsustainable I

- The lack of a sound economic rationale of the requirement to reduce the debt ratio to zero makes the GSP politically unsustainable.
- Intelligent governments do not subject themselves to rules that lack a rational foundation when they come under pressure during a recession.
- This is what happened with France and Germany
- It will continue to happen in the future

The stability pact is politically unsustainable II

- The democratic legitimacy of spending and taxation rests on national governments
- SGP gives authority to European institutions with weak democratic legitimacy to override decisions of national governments
- This should only be done in extreme situations, e.g. debt crises (cfr. IMF in Argentina)
- It should not become routine
- If it does, it will boomerang against the European institutions,
- If EU is used as the IMF, it will become as unpopular as the IMF.

What about flexibility?

- The defenders of the stability pact argue that if countries keep a balanced budget over the business cycle, they will have enough flexibility during a recession allowing them to let the budget deficit increase up to 3%.
- This should be sufficient for most countries to follow an anti-cyclical budgetary policy during most recessions

- Thus the stability pact instructs countries to be on a declining debt path before they can hope to exploit the flexibility of the pact.
- The result of this idea is that the countries that are not on such a path today, are forced to reduce their debt to GDP ratio during the present economic slowdown.
- there is no economic justification for most of the euro zone countries to follow such a strategy in normal times.

- There is even less justification for such a policy prescription during a recession.
- During recessions, debt ratios tend to increase
- Such an increase is desirable to offset deflationary forces

- Official thinking has gone back to pre-Keynesian analysis of government budgets
- One of the great ideas in Keynesian thinking is that there is a savings paradox
- When everybody attempts to increase savings at the same time there will not be much additional saving because of the decline in income

- That’s when the government should step in and start dissaving
- The only exception to this rule is when it moves the government debt into an unsustainable path.
- This is not the case with most Eurozone countries today.

Stability pact and the pension problem

- An often heard argument is the following:
- Future pension liabilities are very high because of greying population
- Let's reduce the debt levels now, so that we create room for more spending on pensions in the future
- In this context the SGP is the right strategy because it forces countries to reduce their debt ratios in anticipation of future increases in cost of old age.

Argument is unconvincing

- This argument implies that governments are now given strong incentives to cut back on investment and to raise taxes
- In order to finance future consumption (pensions)
- This strategy lowers growth potential of Europe
- It lowers incentives to introduce structural reforms in pension systems

- A better strategy is to start structural reforms now, i.e.
  - Stop giving financial incentives for early retirements
  - Stimulating funded pension systems
  - Keep the debt to GDP ratio stable (instead of trying to reduce it).

Towards an intelligent stability pact

This has two components.

1. countries set a medium term target for the debt ratio, say 60%.
   - But it does not have to be 60%, it could also be lower
   - The important thing is that countries target a particular debt ratio in the medium run
   - They are free to choose the most appropriate debt ratio (provided it does not exceed the 60%)

2. deviations around this target are allowed so as to stabilize the business cycle.
   - This implies that if during a recession the debt ratio is overshot, it should decline during the boom, so as to keep the debt ratio on its long run target path.

Here are the possible choices of debt levels and corresponding steady state deficits:

	Required deficits (% GDP) to reach different target debt ratios (nominal growth of GDP = 5%)					
target debt ratio	10%	20%	30%	40%	50%	60%
required deficit	0.5%	1.0%	1.5%	2.0%	2.5%	3.0%

Example:

- Suppose, that the right debt ratio for Germany is 50%,
- this implies that the steady state deficit that Germany should aim at over the cycle is 2.5%.
- Thus even under this more restrictive debt target, there is still no reason to impose a balanced budget over the cycle as the SGP does.

	Required deficits (% GDP) to reach different target debt ratios (nominal growth of GDP = 4%)					
target debt ratio	10%	20%	30%	40%	50%	60%
required deficit	0.4%	0.8%	1.2%	1.6%	2.0%	2.4%

If you think that the long term nominal growth rate is only 4% this means that the steady state deficit to aim at is 2%

- A shift of SGP towards targeting a debt level would be intelligent
- It would also necessitate scrapping the 3% deficit ceiling
- Why? Take example
- A country has, say, 50% debt target.
- Then steady state deficit is 2.5% (or 2% depending on nominal growth assumption)
- Thus during recession 3% limit would almost certainly be breached.

- Debt targeting and 3% deficit ceiling are incompatible
- The 3% rule is last remnant of pre-scientific thinking which was based on idea that the number 3 has a particular hidden meaning

- Another implication of this proposal is that the budget rule is not the same for every country.
- This rule should take into account
  - Debt level
  - Underlying growth rate

How to enforce an intelligent SGP?

- The penalties foreseen in the SGP have no credibility and will never have
- They lack democratic legitimacy
- In addition, if they were to be applied they will have the effect of setting back the European integration
- They could even lead to a break-up
- They have to be scrapped.

- Peer pressure is the only way out
- This is already well organised within the EU
  - e.g: broad economic policy guidelines
  - frequent consultations
  - it works reasonably well
- Independent debt agency
  - either at EU level
  - or at national levels

Conclusion

- The SGP is not an intelligent pact
- That’s why it does not work and will never work
- Democratically elected governments with a lot of responsibilities towards their citizens will not subject themselves to rules that are perceived to be arbitrary
- and that go counter their national interests
- even if these rules are written in a Treaty
- Treaties only last when they are perceived to be in the interest of those who have signed them.

- That’s why the SGP should be reformed along the lines I have spelled out.
- Failure to do so will institutionalize conflict within the EU.