BULLETIN

ECIPE

ECIPE Bulletin No. 13/2014

"Rethink and Reset": Time to get Rid of the Stability and Growth Pact?

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Christine Lagarde, the Managing Director of the International Monetary Fund, recently asked for a "rethink and reset" of the numerical ceilings in the Stability and Growth Pact (SGP). Designed to promote fiscal discipline in EU and euro zone member states, it limits government budget deficits to 3 per cent and public debt levels to 60 per cent of GDP. But exactly what did these ceilings bring, apart from a constant fierce ideological dispute over their enforcement? What would happen if they were abolished? The simple fact is that the SGP has not limited public debt accumulation. Importantly, capital markets do not pay any considerable attention to it. The pact is is still enshrined in EU law, but its flawed foundation, and the aversion to it by governments, is creating enormous costs of policy coordination at national as well as EU level. Arguably, these ceilings are superfluous. If market discipline would be restored, the only necessary component of a SGP is effectively harmonised national statistical accounts, bringing transparency to fiscal policy.

The only constant character of the SGP is its ability to stir political conflict. Numerous infringements of the numerical rules have provoked political clashes, undermining European economic cooperation. Two reforms of the original SGP framework failed to prevent highly emotional political disputes on how to address fiscal indiscipline. Fiscal governance in the European Monetary Union, which will not become a political union anytime soon, still is an unresolvable problem of collective action. This problem is rooted in the great diversion of fiscal policy preferences between sovereign member state governments.

The SGP never tied governments to the mast of fiscal consolidation. Nor did it encourage governments to lead on structural economic reforms. Although the composition and political colour of governments have changed over time, most governments are adversely dispositioned to a supra-national framework that effectively interferes in their fiscal policy. A two-year period of political symbolism in favour of a tighter SGP emerged in 2010, only after capital market discipline seriously constrained government refinancing operations. Ironically, due to the lack of trust in the revised SGP, the Fiscal Compact was set up as an additional safety net.

Now that many countries' are on a fiscal path with public debt levels and deficits way beyond the formal ceilings of the SGP, reform considerations should gain renewed momentum. Although Berlin these days still defends the core provisions of the pact, Paris and Rome insistently keep claiming for budgetary flexibility in favour of domestic fiscal space. Recent calls of Christine Lagarde to "rethink and reset" the EU's ceilings for public debt, in order to account for "how the long-term debt of sovereigns has grown over time", poured additional oil on the heated debate.

Close watchers of the current political haggling in Europe will experience a notable déjà-vu. Between 2001 and 2005, the governments of Germany, France and Italy vehemently claimed for a relaxed SGP. On March 23rd, 2005, the original framework was softened for the first time, after a long political dispute about fiscal sovereignty. Already in January 2003, for instance, Germany's Chancellor, Gerhard Schroeder, welcomed "signs of a more flexible approach within the [EU] Commission to the stability pact." In July 2003, the then Prime Minister of Luxembourg, Jean-Claude Juncker, publicly stated that "we have to have stability. But we have to avoid viewing the stability pact in fetishistic fashion." In May 2004, Nicolas Sarkozy, the French Finance Minister back then, raised doubts about the functioning of the numerical rules: "Is the pact working well when seven of the 15 states are not in line? The answer is no. […] I won't fight for a modification of the three-percent rule. But we have to read the pact in a much more flexible way." Finally, in March 2005, the Italian President Silvio Berlusconi publicly announced to put up a "great fight" for the revision of the original SGP.

Today, fiscal consolidation at EU/EMU member state level is more needed than ever before. Public debt levels are still far from sustainable and do not help to spur economic growth. Fiscal consolidation, however, is not a function of a set of numerical ceilings of a toothless international treaty. For fiscal consolidation to be successful, governments must have an intrinsic motivation to consolidate public finances, i.e. a culture of fiscal stability at

home, or face a hard external budget constraint arising from capital market discipline. The SGP's debt and deficit targets do promote these conditions.

First, a fiscal stability culture will not emerge on the back of numerical rules that lack national political ownership. Fiscal preferences are deeply rooted in the culture and history of a country. Only a few countries, e.g. Switzerland and Estonia, either have a fiscal stability culture or national fiscal rules or both. Most countries and their respective governments lack stability-oriented fiscal preferences. Instead they show a permanent bias towards budgetary deficits. For EU and EMU governments, existing debt and deficit targets impressively failed to correct this bias. Due to record-high public debt levels and the European Commission's lack of enforcement power, governments will continue to treat the overall pact as a set of unwelcome guidelines rather than a hard budget constraint imposed by European law.

Since 2014, all member states of the euro zone are obliged to have a permanent budget rule in line with the guidelines established in the Fiscal Compact, preferably at constitutional level. The budget has to be balanced or in surplus unless there are exceptional circumstances. These provisions will not cause a fundamental change in fiscal policy preferences anytime soon. These days, many Eurozone governments express strong anger about the social and political backlash of fiscal austerity programs. France and Italy, for example, have repeatedly asked the European Commission for room to increase public spending – due to exceptional circumstances. At the same time, the reluctance to enforce far-reaching labour and product market reforms is widespread since governments fear the political costs that comprehensive policy reforms may cause. Since government borrowing is at the same time not constrained by financial markets, national policymakers will hardly establish a stability culture by themselves.

Second, the numerical rules of the SGP do not improve market discipline. Capital markets process various types of information concerning the creditworthiness of governments. In the past, market participants were indeed attentive to the political dispute over the SGP, but failed to execute disciplinary power. Foreign exchange and sovereign debt markets primarily consider fundamental economic data for their portfolio dispositions. Between 2001 and 2005, the euro grew even stronger against major currencies when Eurozone leaders talked down the SGP in response to frequent breaches of the pact's core limitations. Similarly, sovereign credit risk did not respond to the political clashes that seriously undermined the credibility of the SGP.

Many experts agree that market discipline alone is an imperfect substitute for sound fiscal rules. The authors of the 1989 Delors report already stressed that "the constraints imposed by market forces might either be too slow and weak or too sudden and disruptive". An international fiscal rule without teeth, however, is simply inappropriate to complement or even improve market discipline.

The ECB is also tripping up the SGP. In the period of 2001-2005, the ECB and almost all national central banks continuously called for strict enforcement of the pact's numerical rules and procedures. Now the ECB's announcement to stand-by as a permanent lender of last resort for both banks and heavily indebted governments seriously undermine fiscal consolidation and exacerbate the discriminatory impact on the SGP. Needless to say, the core objective of the ECB's monetary policy is not credible unless fiscal policy is effectively constrained.

Consequently, it is time to move away from the fantasy of the SGP being a valuable tool for fiscal governance. The numerical rules of the SGP will not contain public debt accumulation in the EU and the Eurozone. Governments will continue to demand flexible interpretation or suspension of the rules, perhaps even an abolition of the numerical limitations. If these ceilings would finally be abolished, nothing would effectively change. What really matters is the quality of national statistical accounts. EU Council Directive 2011/85 has been the only (Six Pack) legislation addressing this issue so far. Fiscal transparency is an important precondition for both a country's fiscal stability culture and effective market discipline. Timely and regular public availability of harmonised fiscal data for all parts of federal and local governments must therefore be achieved across the EU. Full transparency is superior to one-size-fits-all limitations on member states' public debt accumulation.