

The Stability and Growth Pact – Anchor or Straitjacket?

Public finances in the euro zone have deteriorated in recent years, and a series of conflicts over the fiscal policy of different countries have broken out. The EU Commission and some member countries have criticized Germany and France in particular for violating the rules of the so-called Stability and Growth Pact. However, not only the governments of these countries, but also many independent analysts, argue that strict application of the pact in the current situation would jeopardize the economic recovery. In May of this year, the German government announced that economic recovery had higher priority than short-term compliance with the provisions of the pact. The current situation has intensified the debate on the system of rules for fiscal policy in the euro zone. The new Commission has declared that it is considering certain adjustments in the pact.

The analysis in this box begins by reviewing the reasons why a set of rules for fiscal policy was adopted in the euro zone. To assess the economic effects of complying with the pact, a comparison is made between the results of two scenarios simulated in a model. In one scenario, fiscal policy is assumed to be neutral ahead; in the other, fiscal policy is tightened in accordance with the rules of the Stability and Growth Pact.

Why a Set of Rules?

The system of rules for public finances is intended to keep euro zone member countries from pursuing an overly expansionary fiscal policy. In a monetary union, the costs of an expansionary fiscal policy are less for an individual country than with a national monetary policy and a floating exchange rate. One reason is that the tightening of monetary policy will be more limited – even negligible for a small country – since the central bank focuses on the effect of overall fiscal policy on inflation. Another reason is that there is no national currency vulnerable to speculative attack; this potential source of turbulence on interest markets is thus absent. Moreover, the stimulus to domestic demand will not be counteracted by a stronger currency.

The incentives for an individual country to increase demand with an expansionary fiscal policy

are therefore stronger in a monetary union than with a national monetary policy and a floating exchange rate. At the same time, deteriorating public finances of one member country will have negative effects on the other member countries. A more expansionary fiscal policy that increases inflationary pressure in one country will lead to a tighter monetary policy with higher interest rates in all member countries. In addition, the financial stability of the entire union can be affected if the tendency in the public finances of one country becomes unsustainable. Even though the rules prevent an insolvent country from directly borrowing from the European central banking system,² many analysts maintain that in practice there is an implicit guarantee that affects pricing on financial markets. Thus, an irresponsible fiscal policy in one country will lead to higher risk premiums in bond rates for the other member countries as well and will affect the common exchange rate. Furthermore, the cost of any action to rescue a country from insolvency would be borne by all member countries. Disturbances in the financial system of the euro zone would also afflict all countries. The problem is thus that an individual country in the short run can stimulate its own demand at the expense of the other member countries. As a result, all member countries may find it rational to follow a more expansionary fiscal policy than if they were not members of a monetary union.

The System of Rules

The Treaty of Maastricht, adopted in 1992, stipulates that a net-lending deficit in the general government sector of a member country must not exceed 3 percent of GDP. If this rule is violated, the Ecofin Council will determine the scale of the measures necessary to ensure that the criteria are once again fulfilled. If the member country in question does not take such measures, fines equivalent to 0.2–0.5 percent of GDP can be levied.³ In addition,

² According to some analysts, this provision would be disregarded in a crisis situation. Furthermore, it is legal for the ECB to buy government securities on the secondary market and thereby put downward pressure on the interest rates on a country's debt. This would have an inflationary effect throughout the union.

³ A member country can avoid fines if its GDP has decreased by more than 2 percent in a single year. The decision is discretionary if the decrease in GDP is between 0.75 and 2 percent.

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tion, the Maastricht Treaty stipulates a reference value of 60 percent of GDP as an upper limit to the indebtedness of a country's general government sector. In practice, however, there has been little pressure to observe this rule.

When the Stability and Growth Pact was adopted in 1997, a new medium-term target was added: general government net lending adjusted for cyclical effects, or so-called structural net lending, had "to be approximately in balance or to show a surplus". The medium term refers to the time horizon indicated in the so-called stability programmes,⁴ currently the year 2007.

Background of the Present Situation – Development of Public Finances in Recent Years

The Stability and Growth Pact was drafted at a time when the tendency in public finances was rather favourable. One major factor in the gradual strengthening of public finances during 1993-2000 was the effort to meet the convergence criteria before entering the third phase of the EMU. With the economy strengthening more than expected in 2000, there arose a margin sufficient to meet the targets established according to the pact and to follow an expansionary and procyclical fiscal policy as well. Many member countries then lowered taxes, for example. The Commission, however, criticized a number of countries for not taking advantage of the favourable situation to reinforce their public finances. In 2000, balance in public finances was achieved for the euro zone as a whole.

When the economy weakened the following year, public finances deteriorated rapidly. There was little margin for countering the economic downturn with an expansionary fiscal policy while also meeting the commitments of the stability programmes. The deficit for the euro zone as a whole rose to 2.3 percent of GDP in 2002, then to 2.8 percent in 2003. Most analysts foresee very little improvement this year and next year in public finances within the euro zone. Moreover, it is highly doubtful that Germany and France will meet their commitments

to reduce their deficits in general government finances below 3 percent of GDP by 2005.

Effects of a Tighter Policy

There is thus a substantial risk that the current provisions of the Stability and Growth Pact will not be maintained in the next few years. At the same time, the Commission and several member countries have severely criticized some countries for not trying hard enough to follow the rules.

The question is what effect an application of the pact would have on the development of the economy in the current situation. With the aid of the NiGEM⁵ model for the world economy, the effects are analyzed below for a situation where all euro zone member countries beginning in the first quarter of 2005 take steps to achieve balance in the structural net lending of their general government sectors by 2007. In the experiment, the improvement in public finances is achieved by reducing general government consumption and also indirectly via lower costs of interest.⁶ The latter are due to a decrease in central government debt, and to the fact that the reduction in general government borrowing, together with a more expansionary monetary policy, contributes to lower market rates of interest.

This scenario is compared with one where the structural balance remains at -2.2 percent of GDP, which is the level in the Commission's assessment.⁷ Fiscal policy in the comparison scenario is thus neutral in the sense that the structural deficit is constant. Beginning in 2008, fiscal policy is assumed to be neutral in both scenarios; in other words, the

⁵ NiGEM stands for the National Institute Global Econometric Model. The model is developed by the NIESR, the National Institute of Economic and Social Research, in London.

⁶ One relatively well-established empirical finding is the so-called "composition effect;" in other words, the economic outcome improves the higher the proportion of the fiscal contraction consisting of reduced expenditure and the lower the proportion consisting of increased taxes (see, for example, Alesina, A. & R. Perotti (1996) "Fiscal Adjustments in OECD Countries: Composition and Macroeconomic Effects", NBER Working Paper 5730). Alternative simulations, where a higher proportion of the contraction is in the form of tax increases, show the same properties in the NiGEM.

⁷ The Commission's assessment of the structural balance in the euro zone is based on their estimate of resource utilization. It differs somewhat from e.g. the assessment of NIER. Since the Commission's requirements are based on their own calculation, however, that measure is relevant in this context.

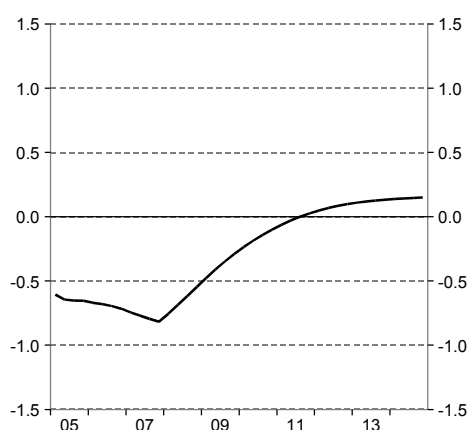
⁴ Within the framework of the Stability and Growth Pact, member countries include in their so-called stability programmes an annual assessment of their public finances, with a specification of any measures taken to achieve financial balance.

difference in the structural balance persists for the entire simulation period.

In general, the tightening of fiscal policy means that domestic demand in the euro zone decreases substantially and that inflationary pressure diminishes. The ECB therefore follows a more expansionary monetary policy, which to some extent offsets the reduction in demand. In addition, the lower rate of interest leads to a weaker euro, thus stimulating exports. In time, stronger public finances also help to stimulate demand, for example through the favourable effect of lower taxes on household finances. The decreases in expenditure lead to lower taxes because there is a budgetary restriction for the general government sector, which means that a smaller debt stock and lower interest rates will result in reduced taxes. After seven years, output is back at the same level as in the comparison scenario. The composition of demand, however, is different since a portion of general government consumption is replaced by private-sector investment, household consumption and exports.

With the tightening of fiscal policy, GDP is initially about 0.6 percent less than in the scenario of a neutral fiscal policy (see Diagram 36).

Diagram 36 GDP: Deviation from a Scenario of a Neutral Fiscal Policy
Percent



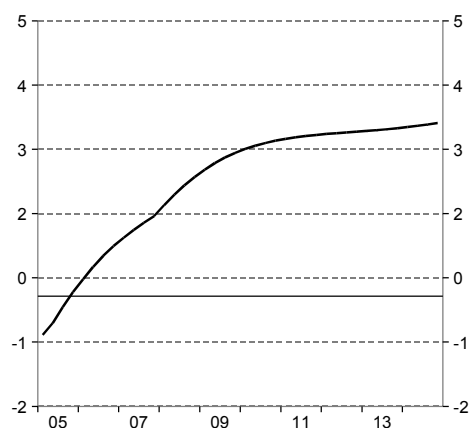
Sources: NIESR and NIER.

The difference in GDP increases until the fiscal contraction ends in 2007. Thereafter, the difference gradually decreases, and beginning around 2011, GDP is roughly the same as in the comparison scenario. In other words, fiscal policy has no long-term effect on GDP, and permanently lower general government consumption is offset by permanently

higher household consumption and investment. Exports are permanently higher as well.

The tighter fiscal policy initially dampens demand. The ECB counters this effect with a more expansionary monetary policy since inflationary pressure is decreasing. In addition, with less general government borrowing, maturity premiums on bond rates are lower, and bond rates are lower in the long run as well.⁸ Both of these effects contribute to a lower real rate of interest. The permanently lower real rate of interest is the main reason why private-sector investment in the longer run is significantly higher than in the comparison scenario with a neutral fiscal policy (see Diagram 37).

Diagram 37 Private-Sector Investment: Deviation from a Scenario of a Neutral Fiscal Policy
Percent



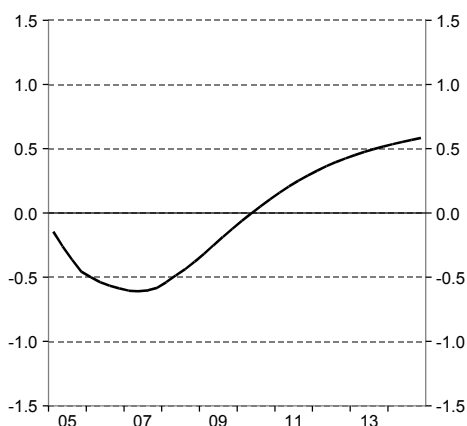
Sources: NIESR and NIER.

In the initial years, household consumption is lower (see Diagram 38), one reason being that unemployment reduces household disposable income.

⁸ Higher general government net lending may be offset by lower household net lending, even if interest rates are unchanged, for example if households believe that an improvement in general-government finances today will lead to lower taxes or higher transfer payments in the future. However, if such effects do not fully compensate for the higher general-government net lending, long-term interest rates will be lower, thereby reducing domestic household net lending and inflows of capital from abroad.

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Diagram 38 Household Consumption: Deviation from a Scenario of a Neutral Fiscal Policy
Percent

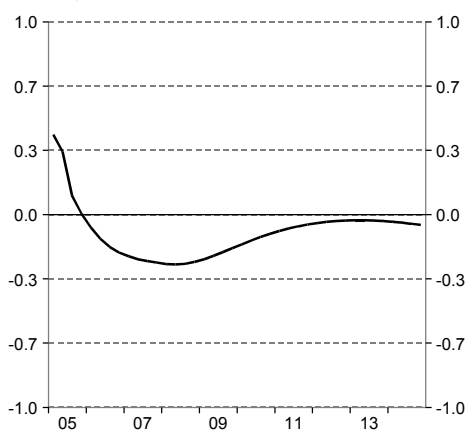


Sources: NIESR and NIER.

But with lower general government expenditure and improved general government finances, the tax burden lessens in time, increasing household disposable income. Households also benefit from rising stock prices and from lower bond rates. These effects gradually come to predominate, and in the long run household consumption is higher than in the comparison scenario.

Since interest rates are lower with a tighter fiscal policy, the exchange rate initially depreciates. It then appreciates somewhat, but even in the long run it is weaker than in the comparison scenario. The weakening exchange rate is one reason for the initially higher inflation. Thereafter, the negative effects on demand predominate, and within a year inflation is less than in the comparison scenario (see Diagram 39).

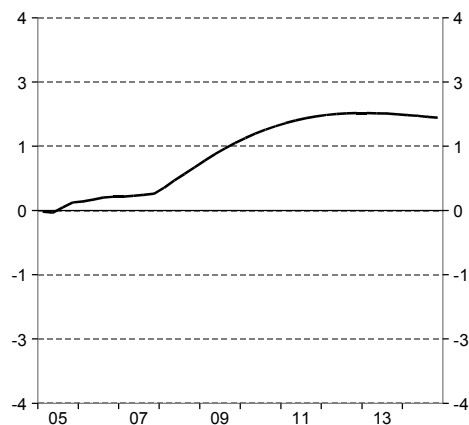
Diagram 39 Inflation: Deviation from a Scenario of a Neutral Fiscal Policy
Percentage points



Sources: NIESR and NIER.

The weakening of the currency means that international competitiveness improves, thus stimulating exports (see Diagram 40). This effect compensates significantly for weaker domestic demand. Moreover, for a long time imports are considerably less than in the comparison scenario.

Diagram 40 Exports: Deviation from a Scenario of a Neutral Fiscal Policy
Percent



Sources: NIESR and NIER.

Concluding Comments

The global economic recovery has been under way for some time, and now the economy is expected to pick up in the euro zone as well; it may therefore be appropriate to begin taking steps to improve general government finances in the euro zone. On the other hand, resource utilization is still low. Recovery in the euro zone is expected to be slow, and there is also a relatively substantial risk of downside surprises.

Simulations with models usually entail considerable uncertainty and require that all assumptions in the model apply. While the findings noted above are no exception, they also reflect the state of empirical knowledge about the effects of fiscal policy. The simulations above indicate that restoring budget balance in accordance with the rules of the Stability and Growth Pact would have significant – though transitory – effects on output. Euro zone GDP would in 2007 be some 0.8 percent lower than otherwise. Given that the current recovery is still tentative, there is a danger that an excessively contractionary fiscal policy might bring it to a halt.

On the other hand, the results do not suggest any dramatic decline in GDP growth. Moreover, the member countries must keep in mind that with the

target of medium-term balance – taking account of factors like the future demographic trend – the alternative is not to refrain from a tighter policy, but to adopt one at another time. It should also be noted that potential effects on confidence are not considered in the model. Violating the rules of the pact could undermine the confidence of economic actors and thus inhibit investment and consumption, for instance through higher risk premiums in interest rates on business and consumer loans. If such effects are substantial, the difference in GDP between the two scenarios as shown by the simulation may be exaggerated.⁹

The question of the right time to restore budgetary balance in accordance with the Stability and Growth Pact has not been discussed here. On the one hand, there is a risk that fiscal contraction may come too early in the business cycle. On the other, it may be even more difficult politically to implement a restrictive policy later on, when public finances look better for cyclical reasons.

⁹ According to certain studies, fiscal contractions, specifically via confidence-building and forward-looking mechanisms, may have positive effects on the economy (see, for example, Alesina, A. & R. Perotti (1996) "Fiscal Adjustments in OECD Countries: Composition and Macroeconomic Effects", NBER Working Paper 5730). However, these findings have been questioned to some extent (see, for example, Hjelm, G. (2004) "When Are Fiscal Contractions Successful? Lessons for Countries Within and Outside the EMU", NIER Working Paper 92).