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WILL FISCAL POLICY IN THE EURO AREA BE SUFFICIENTLY FLEXIBLE TO COPE WITH A MAJOR RECESSION?

BY REETTA SUONPERÄ

Junior Sophister

The current economic downturn has led to countries in the EU exceeding the stability and growth pact. Reetta Suonperä examines the reasons for introducing such a pact, followed by the possible mistakes of EU policy makers, in the way in which the pact has been implemented.

Introduction

The Maastricht Treaty sets limits for government deficits and debt/GDP ratios that should not be exceeded other than in 'exceptional and temporary circumstances', thus setting the rules for fiscal policy in the Euro Area. These regulations are further detailed in the Stability and Growth Pact, which also gives a specification for when the rules can be breached without repercussions. The aim is to achieve fiscal stability, while still maintaining sufficient flexibility to deal with business cycles (IMF, 1997). However, many people now argue that the treaty is too rigid and does not provide sufficient scope for member states to deal with an economic downturn. The debate took a new turn in October 2002, when Romano Prodi, the head of the European Commission, said in an interview with 'Le Monde' that the Stability and Growth Pact is 'stupid' (The Economist, 26.10.2002). His view is that the pact is quite simply too rigid, and that to follow it dogmatically in a changing economic environment would not be wise (Helsingin Sanomat, 22.10.1997).

With the economy in a downturn and the tensions between the US and Iraq increasing insecurity and instability, the ability of the Euro Zone to cope with a major recession is crucial. This essay will attempt to shed some light over this issue by considering the rationale for fiscal rules, both in the general case and for the EMU in particular. Then the Maastricht Treaty and the Stability and Growth Pact will be examined in detail, followed by an exploration of why fiscal flexibility is necessary. Finally, the case of flexibility of the Stability and Growth Pact will be examined, yielding a judgement on whether the pact is sufficiently flexible.

Rationale for Fiscal Policy Rules

Fiscal rules and institutions serve to create the setting in which policy makers operate, and also provide the incentives and constraints for their actions. As these rules and institutions play a large part in determining whether public spending is excessive, resulting in high deficits and accumulating public debt, or moderate, and perhaps more efficient, it is crucial that they are set appropriately (Tanzi and Schuknecht, 2000). Small and effective governments are more conducive to economic growth than large and inefficient governments; high government spending has generally been found to be a net tax on society with few benefits to offer. However, it is important to make a distinction between public consumption and public investment; the former can be detrimental at high levels, whereas the latter tends to have a positive effect on growth (World Bank, 1997).

There is a special need for fiscal rules in the EMU as the creation of a monetary union may result in governments pursuing less prudent fiscal policies. This occurs because governments will find it easier to borrow as the 'domestic' capital market becomes much bigger. Thus the government is able to increase its borrowing without taking on any exchange rate risk, which is associated with borrowing in a foreign currency (Eijffinger and De Haan, 2000). Unsustainable government debt of one country also creates negative spillover effects for the monetary union. The union interest rate will be driven upwards, thus increasing the burden of government debt in other union countries. Now if the other countries have chosen to stabilise their debt-GDP ratios, they will be forced to follow more restrictive fiscal policies. A second spillover effect is that, as a result of the upward movement of union interest rate, countries hurt by this higher interest rate may put pressure on the ECB to relax its monetary stance, thus interfering with European monetary policy (De Grauwe, 2000). It has also been argued that the 'no bailout' clause of the Maastricht Treaty is not credible and that the EMU will essentially provide an implicit guarantee of its members' debts. Thus the risk premium of a heavy borrower would effectively disappear, encouraging the government to borrow more (Eijffinger and De Haan, 2000).

The Maastricht Treaty and the Stability and Growth Pact

The Maastricht Treaty consists of five articles detailing the parameters for fiscal policy as a macroeconomic tool. Article 99 is concerned with policy coordination and surveillance; Article 101 bans monetary financing of a budget deficit; Article 102 prevents governments from having privileged access to credit; Article 103 lays down the 'no bailout' clause, hindering governments from bailing out a member state facing serious financial problems; and Article 104 compels member state governments to avoid excessive budget deficits, with an attached protocol quantifying the criteria for member states' deficits and debt (Brits and De Vor, 2000). These stipulate that government deficit should not exceed 3% of GDP and government gross debt should not exceed 60% of GPD, other than in 'exceptional and temporary' circumstances. These have been specified as either an unusual event outside the control of the member state in question, or a severe economic downturn (IMF, 1997).

The Stability and Growth Pact, which was agreed upon in 1997, clarifies the rules set out in the treaty. The pact pays particular attention to the circumstances where the 3% rule for budget deficits can be exceeded, and details timing and magnitude for sanctions imposed on a member state with an excessive budget deficit. Further, members of EMU commit to having a budget 'close to balance or surplus' in the medium term. The objective is to allow governments to deal with normal cyclical fluctuations, while still keeping to the reference value for budget deficits (Eijffinger and De Haan, 2000).

The most important elements of the Stability and Growth Pact are laid down in two Council regulations (Numbers 1466 and 1467, 1997). The first Regulation strengthens the surveillance of budgetary policies, requiring members of the EMU to submit to stability programmes, which are made public and must be updated annually. The second Regulation was created to speed up and clarify the sanctioning process in case of excessive deficits. It also details that a budget deficit in excess of 3% is allowed only when this is caused by an unusual event outside the control of the member state, or by a severe economic downturn. The latter is defined as an annual decline of at least 2% of real GDP (Brits and De Vor, 2000).

Why is Fiscal Flexibility Necessary?

The Stability and Growth Pact focuses on achieving fiscal discipline in the EMU, while still allowing governments sufficient flexibility to deal with normal business cycle fluctuations (IMF, 1997). It is essential that this flexibility be maintained, since the use of monetary policy is no longer an option for members of EMU (De Grauwe, 2000). Government spending acts as an automatic stabiliser. Tax revenues decrease in a recession while public spending increases and the opposite happens when the economy is thriving; the effects of the cyclical nature of the economy are dampened by budget deficits. A budget in deficit is therefore not necessarily a sign of imprudence on the part of the government and an active fiscal policy is revealed by changes in non-automatic budget balances, also called the structural component. Fiscal activism was very popular after World War II, especially in the 1970s and 1980s, but tends to be frowned at today because of the risk of amassing unsustainable government debts. However, it is important to note that active fiscal policy may be required to deal with a severe recession (McAleese, 1997).

The need for fiscal intervention can be caused by external or internal shocks (McAleese, 1997). Shocks can be symmetric or asymmetric in nature, as well as permanent or temporary. Different types of shocks require different types of measures. Shocks that are symmetrically distributed across EU countries should not be very difficult to deal with; however, external leakages of fiscal stabilisation may pose a problem, especially to smaller, open economies. It is also worth noting that countries' ability to deal with symmetric shocks is dependent on the degree of structural flexibility in the country; thus, the greater the flexibility in national markets, the less likely that significant deviations in performance will occur. Asymmetric shocks are more serious in nature, as common policy responses can be less effective and loss of independent monetary and exchange rate policies at the national level may prove to be more constraining. The nature and magnitude of problems arising due to asymmetric shocks will depend on whether they are temporary or permanent, the scope for fiscal policy to cushion shocks and structural flexibility (IMF, 1997). It is uncertain whether EMU will increase or decrease the likelihood for asymmetric shocks. On the one hand, it can be argued that a macroeconomic policy striving towards stability, will reduce policy induced shocks and that monetary integration will lead to an intensification of intra-industry trade, resulting in greater cross-country symmetry. On the other hand, in the long run EMU might result in regional specialisation, resulting in an increased likelihood for asymmetric shocks (Brits and De Vor, 2000).

A factor that causes the Euro Area to be vulnerable to asymmetric shocks is the lack of labour market mobility. Monetary policy can no longer be used as a tool to cope with shocks and fiscal policy is subject to restraints. As a result, labour mobility would appear to increase in importance. However, the labour markets within the EU are faced with linguistic and cultural barriers, making a substantial increase in labour mobility across state borders unlikely. This takes the focus back on fiscal transfers. There are two schools of thought here, one arguing for increased fiscal flexibility and one proposing a centralised, federal fiscal authority. As the latter alternative is extremely politically sensitive, and any proposal to increase the EU budget has been met by strong opposition, it would seem that increased fiscal flexibility is the only viable alternative (Dyson, 2000).

Is the Stability and Growth Pact Sufficiently Flexible?

National fiscal policies in the EMU must find a balance between two conflicting objectives, sufficient budgetary flexibility cope with asymmetric shocks and the need and desire to avoid unsustainable government debts. The stability and growth pact has been guided more by the fear of unsustainable debt rather than the need for fiscal flexibility. This can reduce the capacity of national budgets to act as automatic stabilisers during recession, thus protracting the downturn. The question is to what extent this is the case. Experience from the period 1991-1993 shows that budget deficits in excess of 3% are not uncommon. Of the nine EU countries, six exceeded the 3% rule, while only three would have been able to invoke the exceptional circumstances clause, suggesting that the pact goes too far in reducing budgetary flexibility and interferes with the role of national budgets as automatic stabilisers (De Grauwe, 2000).

However, these figures are from a time when fiscal balance was not yet a significant objective for governments. Estimates by IMF staff (1997) show that, on average, a 1% shortfall in output from potential worsens the fiscal balance by 0.6%, with the impact being of the order of 0.75% or higher for Denmark, the Netherlands, Sweden, and the UK. In other words, where the budget is in structural balance and the cyclical response parameter is of average size, automatic stabilisers accommodate an output gap of 5% with the budget deficit remaining below 3% of GDP. In countries with a higher response parameter, an underlying surplus of 1% of GDP is required in order to provide the same buffer. Thus it would appear that the Stability and Growth Pact provides adequate scope for automatic stabilisers to function appropriately, given that countries maintain balanced medium term structural balances, or a small surplus in the case of above-average sensitivity to fiscal fluctuations. Nevertheless, it should be noted that countries with high potential output levels could face problems in keeping to the 3% rule in a severe downturn.

However, one problematic scenario that could arise is if a cyclical downturn were to occur soon after the start of the EMU, when many countries have not yet reached the medium term goal for fiscal balances. Enforcing the Stability and Growth Pact in such circumstances would be likely to result in public and political discontentment, but not adhering to the Pact could erode the credibility of the Pact (IMF, 1997). This is described by the IMF as 'a particularly difficult case — though not one envisaged in the IMF staff's projections' (IMF, 1997; 60). However, most member states entered the EMU with government deficits just below the 3% limit, and a distinct lack of ambition to achieve a budgetary position 'close to balance or in surplus' was widespread (Brits and De Vor, 2000).

Currently the economy is experiencing a downturn and the target for medium term budget balances have not been reached. As a result the Stability and

Growth Pact is facing serious problems. Portugal had a deficit of 4.1% in 2001, Germany estimates that its deficit will be of the order of 3.7%, while France and Italy are coming dangerously close to the limit (Economist, 26/10/2002). Some call for changes in the pact, whereas others question the shortsightedness of those responsible for the pact. As MEP Helsingin Samomat said to Romano Prodi whilst as one of his criticisms of the pact: 'It should not come as a surprise for the Ministers of Finance or the Commission that after economic growth comes a downturn' (22/10/2002). This is the main problem with the pact; the estimations for economic growth were overly optimistic at the time when it was agreed upon and a downturn has occurred before any sort of medium term balance has been achieved. Thus the problem is not the pact itself, or the allowances it makes towards flexibility, but rather the overly optimistic assumptions behind it. The pact has the potential to deliver, but due to unforeseen changes in the economic climate, it may not able to do so. The question remains, why was the possibility of an economic downturn not taken into account while the pact was being devised. The most likely answer is given by Sanomat, when he told Romano Prodi that downturns follow growth and as a result, shortsightedness could be blamed for the pact's current breaches. Perhaps when the pact was introduced, it should have been phased in more slowly, to allow for budgetary readjustment.

Conclusion

There is no doubt that the Stability and Growth Pact is in crisis. With several countries either very close to, or surpassing the 3% rule, the credibility of and commitment to fiscal stability in the EMU is being called into question. Fiscal rules seem to be a necessity, given the track record of excessive budget deficits and the unsustainably high levels of government debt in many European Union countries, but having a system that can so blatantly be ignored is not what the EU needs. However, it is not the Stability and Growth Pact itself which is faulty. The pact does provide a sufficient degree of flexibility to deal with a recession, even a major one; it was with such a scenario in mind that the 'temporary and exceptional circumstances' clause was designed. What the architects of the pact did not envisage was the downturn in the economy that has occurred since the year 2000 and as medium term budgetary balance has not yet been achieved, many countries face problems. The best approach in this situation may be to acknowledge the mistakes that have been made and to devise ways of improving the situation. A short-term loss in credibility will be paid off in the long term with a functioning European Union and perhaps a lesson has been learned with respect to myopia in the design of long-term policies.

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