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Topic 1

Opinion on a reformed Stability and Growth Pact

Opinion on a Reformed Stability and Growth Pact

Briefing Paper for the Monetary Dialogue of May 2005 by the Committee on Economic and Monetary Affairs of the European Parliament with the President of the European Central Bank

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Abstract

In March 2005, the Council of Economics and Finance Ministers (Ecofin) presented its own suggestions for a possible Stability and Growth Pact (SGP) reform in a Report to the European Council. The Council Report divides its proposals in three parts, namely improving governance, strengthening the preventive arm and improving the implementation of the Excessive Deficit Procedure (EDP). The present paper contains a critical analysis of the ideas inherent in the Report, accompanied by comparisons of the suggestions to earlier proposals for reform in the literature and the Commission Communication of September 2004. It will be argued that the Report does address some fundamental issues, especially with regard to the correction of the pro-cyclical bias or the excessive uniformity of the rules. However, the proposals are insufficient to reform the SGP satisfactorily, but rather stay on the 'soft side' avoiding addressing core issues such as partisan enforcement and sanctions. The belief that the suggestions made in the Report will be a big step forward is thus heavily based on the assumption that over the last years governments have become a lot more credible in their (renewed) commitments, even when facing virtually no negative consequences of breaking them.

Introduction

Since the first countries broke its rules, the Stability and Growth Pact (SGP) has been under fire, with many arguing for reform and some even for its abolition. Especially the enlargement of the European Union by ten new Member States has fed the discussion whether the uniform rules of the Pact are still appropriate for countries that are considerably heterogeneous and economically diversified. In addition to the call for more flexibility, experience has shown that countries do not behave prudently in good times, which indicates that the Pact is asymmetric in nature, not giving the right incentives to fiscal policy-makers during economic upswings. With respect to enforcement and implementation, the problems of the SGP reached its preliminary climax in November 2003 when the Council of Economics and Finance Ministers (Ecofin) suspended a Commission recommendation to start sanction procedures against Germany and France - a decision that has been annulled by the European Court of Justice in July 2004. This Court ruling made a rethinking of the Pact's rationale, rules and implementation unavoidable. As a reaction to the SGP's problems in general and this Court ruling in particular, the European Commission has published in September 2004 a Communication, in which it presents proposals on how to enhance the effectiveness of the Pact's rules. In March 2005, the Council of Ministers presented its own suggestions for a possible SGP reform in a report to the European Council.[1] This report underlines the willingness of the Council to keep the Pact alive and unchanged in its rules-based approach and its basis on the two nominal anchors of 3% of GDP for the deficit ratio and 60% for the debt ratio. According to the introduction of the Report, the proposals made aim at

- Strengthening and clarifying the implementation of the SGP
- Enhancing the economic underpinnings of the existing framework
- Better catering for differences between economic conditions in different Member States
- Keeping the rules as simple and transparent as possible

Specifically, one of the declared goals of the suggestions that are presented in the Report is "*not to increase the rigidity or flexibility of current rules but rather make them more effective*"[2].

The present paper contains a critical analysis of the ideas inherent in the Report, accompanied by comparisons of the suggestions to earlier proposals for reform in the literature and the Commission Communication of September 2004. It will be argued that the Report does address some fundamental issues, especially with regard to the correction of the pro-cyclical bias or the excessive uniformity of the rules. However, the proposals are insufficient to reform the SGP satisfactorily, but rather stay on the 'soft side' avoiding addressing core issues such as partisan enforcement and sanctions.

[1] Annex II of the Presidency Conclusions, Brussels 22 and 23 March 2005, hereafter referred to as 'the Council Report (2005)'.

[2] Council Report (2005), p. 2.

The Council Report divides its proposals in three parts, amely improving governance, strengthening the preventive arm and improving the implementation of the Excessive Deficit Procedure (EDP). In the following, the Council suggestions put forward in each of these parts will be first shortly presented and then commented on.

I. Improving governance

The first area in which the Council sees room for improvement is governance[1]. Having affirmed that the respective institutions involved in the SGP should "deliver on their respective responsibilities"[2] and respect each other's tasks, particularly the following points are mentioned to improve governance and national ownership:

(1) Effective and timely cooperation and communication between the institutions and the public and between the institutions themselves;

(2) Improved peer support and peer pressure based on a yearly assessment of national budgetary developments and their implications for the Euro area as a whole;

(3) Complementary national budgetary rules and institutions to enhance national ownership;

(4) A stability/convergence programme for the whole legislature when a new government has taken office, furthermore a plead for continuity in that case with respect to the budgetary targets endorsed by the Council;

(5) Involvement of national Parliaments in stability/convergence programmes;

(6) Reliable macroeconomic forecasts based on Commission forecasts;

(7) Enhanced quality, reliability and timeliness of fiscal statistics.

Improving governance surely is of certain relevance in reforming the SGP. The fact that the Council feels compelled to mention that the respective institutions involved in the SGP have to respect each other's tasks is revealing in this respect, but not surprising given that one of the SGP's more recent problems actually was that one institution (the Council) largely neglected another's (the Commission's) role as 'guardian of the Treaty and its procedures'[3] by not imposing the recommended sanctions on France and Germany despite their non-compliance with the rules of the SGP. But there is more to it: merely stating that Member States, the Commission and the Council have to respect each other's responsibilities will not help to prevent a situation like the one of November 2003. Instead, as pointed out by Buti, Eijffinger and Franco (2003) and Eijffinger (2004), in order to enhance non-partisan enforcement of the rules, the Commission would need more power in the decision on sanctions, e.g. by issuing proposals instead of recommendations to the Council. However, the Council Report clearly stresses that the institutions must deliver on their responsibilities *while avoiding any institutional shift*.[4] It remains to be seen whether the Council would interpret a strengthened role of the Commission in imposing sanctions as institutional shift or as respect of its role as guardian of the Treaty and its procedures.

In spite of the undeniable importance of governance for the effectiveness of the SGP, the question remains to which extent the issues put forward in the report will actually improve it. In fact, these issues can be divided into three groups. The first group embraces point (1) and the general affirmation on institutions having to deliver their respective responsibilities – it is basically a re-confirmation of tasks and behavioral rules that should have already been clear anyway as inherent in the original Pact. As such, there is not much new to it and it is doubtful

[1] pp 4-7 of the Council Report (2005).
[2] p 4 of the Council Report (2005).
[3] Council Report (2005), p. 4.
[4] Council Report (2005), p. 4.

whether the mere statement of the need for improvement in these areas will really make a difference.

Points (2), (3), (4) and (5) constitute the second group – suggestions for which it is questionable whether improvements will really materialize. As Gros (2005) states, peer support and peer pressure (2) for fiscal discipline, which is according to the Council report an 'integral part of a reformed SGP'[1], have so far proven ineffective.[2] However, increased national ownership in the form of complementary budgetary rules and institutions (3) or more involvement of national Parliaments in stability and convergence programes (5) will not be a guarantee of improvement either in the light of the German experience. How much more can rules be nationally owned when they are already anchored in the Constitution of a country?[3] In the German case, this clearly did not help to ensure compliance with the rules even though the budget and deviations of it have to be presented to and discussed in Parliament. Finally, with respect to (4), the Council merely *invites* new governments to show continuity and provide for a stability programe for the whole legislature, which is in the end just a plea for yet another political commitment where neither compliance is rewarded nor non-compliance is punished. In sum, even if they are implemented as foreseen, one should be rather cautious to expect suggestions (2)-(5) to deliver substantial improvement in governance.

Finally, suggestions (6) and (7) denote useful ideas to improve the 'SGP infrastructure', that is, underlying conditions that are crucial for the functioning of the Pact. In accordance with Eijffinger (2004), the importance of reliable macroeconomic forecasts (6) to prevent a 'hidden undermining of the SGP'[4] due to forecast errors is recognized. It can only be welcomed that the Council Report gives a prominent role to the independent Commission forecasts in Member States' projections and the assessment of their macroeconomic and budgetary developments. Following the Commission Communication of 3 September 2004, emphasis is also put on the quality, reliability and timeliness of fiscal statistics (7), which is an issue that the Council and the Commission are to deal with in more detail in the course of 2005. Especially if the provision of unreliable low-quality data is subject to sanctions, this will certainly increase transparency of budgetary positions and will enhance financial markets' ability to properly assess the creditworthiness of a Member State.

All in all however, the suggestions to improve governance, which is desirable as such, are not convincing and to a large extent not straightforward enough to make much of a difference in practice. Except for the last two, they are rather guidelines and statements of intention heavily dependent on the good will of Member States than readily enforceable improvements.

[1] Council Report (2005), p. 5.

[2] Gros (2005) in *Intereconomics – Review of European Economic Policy*, Vol 40, p. 17.

[3] Article 110 (1) on Federal Budget and Budget Law of the German Basic Law states that: "… The budget shall be balanced with respect to revenues and expenditures."

[4] Eijffinger (2004), p. 4.

II. Strengthening the preventive arm

The second area that the Council Report on improving the working of the SGP deals with is a strengthened preventive arm[1], that is, the (renewed) commitment of Member States to budgetary consolidation in periods of growth above trend in order to avoid pro-cyclical policies and an excessive debt or deficit level in bad times. Specifically, three points are put forward in this context:

(1) Differentiation of the medium-term budgetary objective (MTO) across Member States taking into account differences in the economic and budgetary situation of the countries: the MTO (in cyclically adjusted terms, net of one-off and temporary measures) will be between -1% for low debt/high potential growth countries and balance or surplus for the high debt/low potential growth countries; implicit liabilities (especially those connected to the ageing of the population) should be taken into account as soon as criteria to appropriately deal with them are established and agreed upon;

(2) Adjustment path to MTO: commitment to actively consolidate public finances in good times using unexpected extra revenues for deficit and debt reduction, the benchmark for adjustment to the MTO being 0.5% of GDP annually; in case of non-compliance, policy advice early warnings (when the Draft Constitution is ratified) are issued by the Commission;

(3) Structural reforms: major reforms with direct long-term cost-saving effects (especially pension reforms) are taken into account when assessing the adjustment path towards the MTO allowing for temporary deviations given the 3% limit is respected and the budgetary position is expected to return to the MTO within the programe period.

Enhancing the commitment for fiscal discipline also in good times to tackle the asymmetric nature of the Pact has for a long time been demanded for in the literature. Creating incentives to behave prudently in good times and thus correcting the pro-cyclical bias by means of early warnings issued by the Commission has already been proposed by Buti, Eijffinger and Franco (2003) and also reappeared in the Commission Communication of September 2004. In the light of this, the proposition on defining an adjustment path towards the MTO (2), which is - if necessary - accompanied by policy advice, is an overdue step in the right direction. Still, an annual adjustment of 0.5% of GDP is just a benchmark and it remains to be seen whether in practice some consistency will be noticeable on how much more than 0.5% should be corrected for in good times and how much less it may be when economic conditions are not that favourable, without letting full discretion in the strictness of its interpretation make this benchmark meaningless. Regarding the non-compliance with the prescribed adjustment path, a warning issued by the Commission is a more effective tool to create incentives to behave prudently than a pure policy advice. However, for direct warnings to become feasible, one still needs to wait for the lengthy process of the ratification of the Draft Constitution. Consequently, this improved mechanism cannot be expected to become effective in the very near future.

[1] Council Report (2005), pp. 8-11

The other two points put forward by the Council address what Buti, Eijffinger and Franco (2003) have identified as 'excessive uniformity of the rules'. Making the MTO dependent on the debt level, potential growth and eventually also implicit liabilities resulting from demographic changes (1) better accounts for country-specific differences in a European Union with increasingly heterogeneous Member States and rewards countries with relatively low debt levels and sustainable budgets allowing them a less stringent MTO. In this point, the Council exactly follows the reasoning of the European Commission (2004). Point (3) again concerns the adjustment path towards the MTO, allowing for country-specific deviations when structural reforms with long-term cost-saving effects have been undertaken. In this way, it can be avoided that the implementation of urgently needed reforms is delayed or given up in order to be able to follow a too stringent adjustment path.

In sum, it is fair to say that the improvements suggested in the area of the 'preventive arm' largely respond to calls in the literature for more flexibility/less uniformity of the rules and for earlier actions to correct inadequate budgetary developments. Nevertheless, it might be questioned whether warnings and commitments to prudent behaviour in good times are effective given that they seem not to be working in bad times. Two points have to be mentioned in this respect (a third one will be stressed later on). On the one hand, good times provide more room for manoeuvre anyway as Member States face the 'problem' of how to spend 'unexpected extra revenue' for which no specific expenditure plan exists, whereas in times of economic difficulties, governments of Member States with an excessive deficit (ED) would have to reallocate money, that is foreseen for other projects already, to debt and deficit reduction, which is always more difficult. On the other hand, using unexpected extra revenue for deficit and debt reduction leads to lower debt levels, which in turn is rewarded with a relaxed MTO and more flexibility in government spending. As a result, the proposals put forward may indeed contribute substantially to correct the pro-cyclical bias of the Pact.

III. Improving the implementation of the EDP

Finally, the Council Report focuses on the clarification and possible improvements in the implementation of the Excessive Deficit Procedure (EDP)[1]. Issues dealt with include

1) the preparation of a Commission report on the existence of an ED;
2) a widening of the definition of an 'exceptional and temporary' ED over the reference value to cover all periods of negative growth and protracted periods of sluggish growth compared to potential growth;
3) the clarification of 'all other relevant factors' taken into account when assessing the ED given it is temporary and close to the reference value, namely potential growth, prevailing cyclical conditions, policies to foster R&D and innovation, implementation of policies in the context of the Lisbon Agenda, fiscal consolidation efforts in good times, debt sustainability, public investment and the overall quality of public finances; special consideration is given to possible high levels of financial contributions to foster international solidarity and to achieving European policy goals (unification of Europe);
4) special attention to systemic pension reforms considering the net cost of the reforms for the initial five years after introduction when assessing whether the ED has been corrected;
5) the increasing focus on debt and sustainability through Council recommendations (issued in the framework of the Council opinion on the stability and convergence programmes) on debt dynamics for Member States above the reference values;

[1] Council Report (2005), pp. 11-18

6) the extension of deadlines for the adoption of decisions and for taking effective action and measures in order for Member States to better frame actions on recommendations within the national budgetary procedure;
7) the extension of the initial deadline for correcting an ED from 1 to 2 years conditional on special circumstances identified based on an overall assessment of 'all other relevant factors' (see point (3));
8) the revision of deadlines for correcting the ED in case of unexpected adverse economic events with major unfavourable budgetary effects occurring during the EDP.

Whereas (1) just reconfirms the status quo stressing the Commission's responsibility to prepare a report identifying whether an excessive deficit exists and whether any exceptions apply that might make the launch of an EDP needless, the second group of issues - points (2)-(5) - focuses on exceptions giving Member States the possibility to escape an EDP in spite of deficits above the reference value. Points (6)-(8) finally deal with the correction of excessive deficits in the procedure, in particular with the deadlines prescribed in the Pact.

In both suggestions (2) and (5), the Council again closely follows proposals made by the European Commission (2004) strengthening the economic reasoning of the Pact. Especially the increased focus on debt and sustainability is of particular importance in addressing the demographic problem, which is probably not stressed enough given that the implicit debt stock is already two to three times higher than the official debt stock in many EU Member States according to Hefeker (2005). Turning to points (3) and (4), even though any clarification of the term 'all other relevant factors' is highly useful to limit the room for discretionary interpretation of when an exception might be justified and even though pension reforms may have a substantial impact on future budgetary developments, the diversity of situations introduced that have to be taken into account when assessing a Member State's deficit is so broad that virtually every country with a temporary deficit close to but above the reference value can find a way to escape the EDP. This escape effectively raises the reference value to whatever is in practice considered close enough to the original 3 % to make the exceptions apply. However, if the MTO and prudent behaviour in good times were taken seriously, these 'EDP-escape options' would not be necessary as the 3 % deficit limit or, even more strictly, the 1 % MTO limit and the adjustment path towards it leave enough room to finance policies such as the ones mentioned under (3).

The envisaged extension of the various deadlines in the EDP is subject to similar considerations as above. Introducing special circumstances under which the deadline for correcting an excessive deficit is extended - points (7) and (8) - opens the door to abuse of this clause by re-interpreting conditions as special with the consequence of providing a legal possibility to escape sanctions even when the excessive deficit is not corrected in time.

Solely point (6), embracing among others the extension of the deadline (from 4 to 6 months) for the timing of taking effective action, is based on solid arguments. As the Council notes, extending this deadline allows Member States to better frame their action to correct an ED within the national budgetary procedure and to develop structural rather than temporal measures.[1]

[1] Council Report (2005), p. 16

In general, the Pact should be kept as simple and transparent as possible, thereby avoiding special provisions as much as possible. As Eijffinger (2004) states, simplicity should be given up "*if and only if at the same time not only flexibility but also effectiveness through better enforcement of the Pact is enhanced*".[1] In the case of the deadlines and the identification of an excessive deficit, the special circumstances that have to be taken into account seem to be designed rather to escape enforcement than to enhance it. In any case, introducing them does not improve fiscal discipline in Europe but unnecessarily complicates the Pact.

Interestingly, while mentioning every step in the EDP including less important issues such as the reconfirmation of the Commission's role in preparing a report on the existence of an excessive deficit in a Member State, the Council Report devotes no attention at all to the final step in the EDP - the imposition of sanctions if the ED is not corrected within the prescribed timeframe - despite the fact that the roots of much of the Pact's recent trouble and as such most room for improvement lie in this area. Cynics may claim that the Council has simply recognized that sanctions *need not* to be dealt with, given that the special provisions introduced with all the possibilities to escape the EDP will make sure that no country ever gets in the situation of facing sanctions. Whatever the reasons for not mentioning sanctions might be, neglecting this crucial part of the SGP is a major flaw in the Council Report.

Figure 1 illustrates how sanctions fit into the general framework for achieving fiscal discipline. The institutions mentioned on top of the graph are responsible for the governance of the fiscal rules, for timely and complete communication and – in the case of Member States – for national ownership of the SGP rules. Good times should be used to consolidate budgets (→ prevention), which is dealt with in the Council Report under 'strengthening the preventive arm'. In times where a Member State has problems to comply with the fiscal rules, which will probably but not necessarily occur during an economic downturn, excessive deficits subject to the EDP should be identified (→ identification of ED) and corrected (→ correction of ED), otherwise, sanctions are imposed (→ sanctions). Whereas the identification of an excessive deficit is done by the Commission, its correction is fully in the hands of Member States whose willingness to comply with the recommendations for adjustment crucially depends on whether or not the threat of sanctions is credible and on the cost of these sanctions. When a country does not have to fear any (severe) punishment, it will not feel urged to correct its deficit in a timely manner – with or without extended deadlines. In other words, the right incentives will just be given in the presence of credible and costly sanctions. As the example of France shows, the problem stems not so much from the limited *ability* but primarily from the lacking *willingness* to correct the excessive deficit as fast as possible.

Additionally, Figure 1 highlights another reason why Member States would be willing to commit themselves to prudent policies in good times, a question already raised in part II. The threat of sanctions, if credible, will give an extra incentive for Member States to consolidate their budgets when possible (thus, in good times) in order to not get into an EDP in the first place. Therefore, credible and sufficiently high sanctions play a crucial role for both Member States' commitment to adjust EDs and their willingness to behave prudently in good times. This implies that 'improving the implementation of the SGP' (title of the Report) means to a great extent 'improving the credibility of the threat of sanctions'.

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[1] Eijffinger (2004), p. 6

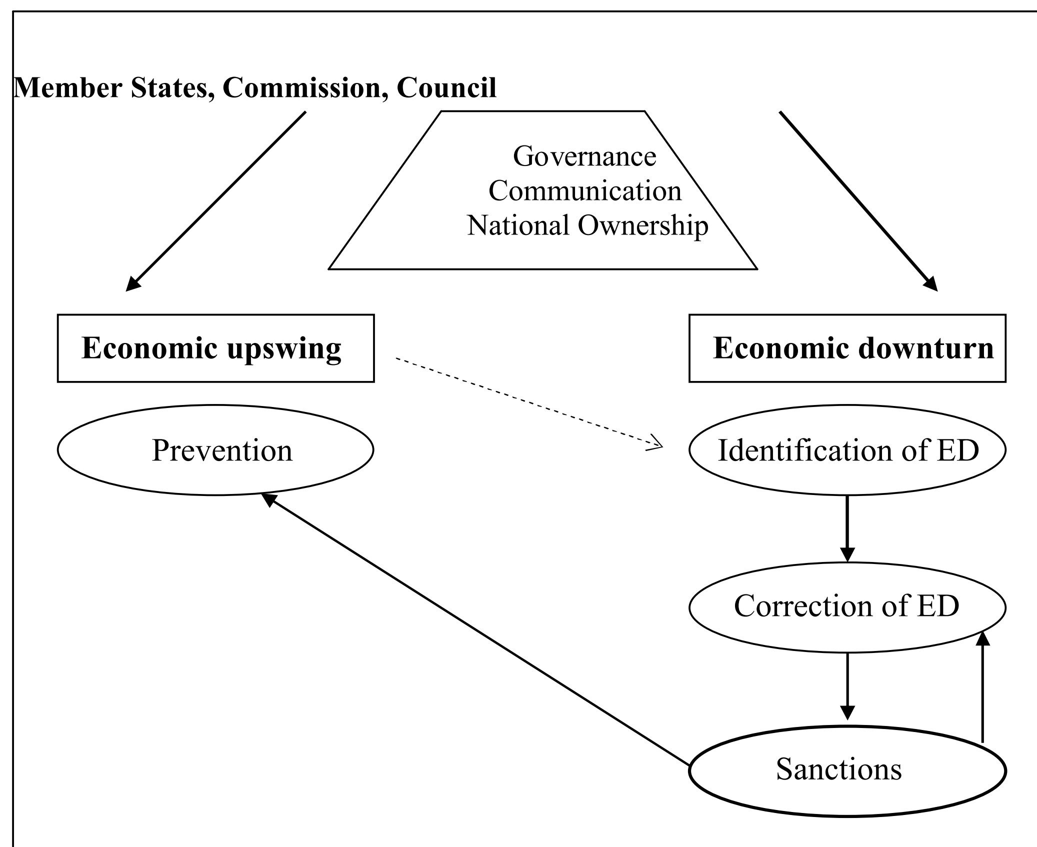
The proposition of Buti, Eijffinger and Franco (2003) to base the decision of the Council on sanctions on a Commission *proposal* instead of a *recommendation* would be an important step in that direction as unanimity is required to move away from a proposal. Thus, less discretion is left in the hands of the Council, in which the same Ministers of Finance being responsible for the national budgets and hence the excessive deficits have to decide on sanctions.

General Evaluation

The Council Report on improving the implementation of the SGP addresses a variety of issues concerning the SGP. In its assessment, especially regarding the suggestions aimed at strengthening the preventive arm of the Pact proved to be useful. Other problems of the current SGP framework that are tackled concern the attempt to overcome the excessive uniformity of the rules by taking into account debt and sustainability in the definition of the MTO and the attempt to increase transparency by means of more reliable statistics and economic forecasts. Despite these useful elements, the Report contains a lot of suggestions that are either unlikely to really lead to improvements (see for example the ones aimed at improving governance) or that will even weaken or complicate the Pact without improving fiscal discipline (see e.g. the part on improving the implementation of the EDP). Besides, comparing the actual proposals to the statement in the Introduction (see quote on page 1) reveals that some suggestions *do* increase the flexibility of the rules to a certain extent, that is in the new definition of the MTO depending on debt and sustainability levels, while the many possible exceptions for avoiding an EDP is effectively watering down the stringency of the 3% reference value. In this respect, the Council Report does not even keep up with its own declared objectives. One of the main flaws of the Report is that it disregards the core issue of making the SGP rules more effective by (non-partisan) enforcement, especially regarding the imposition of sanctions. Member States' commitment to comply with the fiscal rules also in bad times can be ensured when non-compliance is rather probable and costly and thus not desirable. In this context, the reputational costs for a Member State of being in the EDP or having to pay fines are often put forward as a deterrent for a country to run into excessive deficits. These reputational costs could certainly play a role for countries that had never an excessive deficit before. However, once a country is repeatedly breaching the rules, its reputational cost will diminish. Therefore, imposing sanctions on a Member State with a continuing excessive deficit are the only effective tool to give the right incentives towards fiscal discipline. In contrast, the proposals put forward by the Council Report seem to be characterized by an averseness to punish any country.

They are largely relying on the hope that 'national ownership' and 'renewed commitments' will do the trick. 'National ownership' seems to be the new trendy remedy for failed commitments, both with respect to the Lisbon Agenda and the SGP. Time will reveal whether the newly acquired prominent role of these terms in the European jargon is justified. Leaves one question: why would 'renewed commitments' to fiscal discipline work better than the original ones of a few years ago? If enforcement is not enhanced, they simply won't. The belief that the suggestions made in the Council Report will be a big step forward is thus heavily based on the assumption that over the last years governments have become a lot more credible in their 'renewed commitments', even when facing virtually no negative consequences of breaking them. In this case, a simple and credible commitment to fiscal discipline in EMU would have been sufficient. This did not prove to be feasible under the present circumstances. Europe is waiting for renewed leadership within the large countries!

Figure 1: The General Framework for Achieving Fiscal Discipline



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Opinion on a Reformed Stability and Growth Pact

Briefing Paper for the Monetary Dialogue of May 2005 by the Committee on Economic and Monetary Affairs of the European Parliament with the President of the European Central Bank

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So much has been written on the Stability Pact that it does not seem to be useful to repeat the arguments why deficits need to be reduced. This short note thus focuses only on the official reasons given for changing the Stability Pact (SGP).

The reasons given for the so-called reform of the Stability Pact do not look credible in the light of the actual behaviour of fiscal policy.

One reason often given for the need of a reform is that the SGP would force countries to adjust "too quickly". This argument sounds hollow if viewed against the fact that a country like Germany will this year probably run an excessive deficit for the fourth year in a row. It is difficult to see how the 'old' SGP has force major countries into an excessively quick adjustment.

Another argument given for the need for reform is that one should look at the longer run. After all, an occasional deficit somewhat in excess of 3% of GDP should not be considered the end of the world. Put in this way, the argument is correct. But the argument sounds again hollow if viewed against the actual long-term trends in public finance. A recent study by a major rating agency shows that under current trends all three major euro area country governments will sooner or later face junk status because their debt levels will explode. These governments are now effectively saying that they wish to be free to do even less fiscal adjustment than they have undertaken so far. Hence the hypothesis that current trends will continue might even be optimistic.

It is not yet known officially how the Stability Pact will be 'reformed' in the sense that the legal texts that make up the Stability Pact have not yet been changed. But the political basis for the reform is the report from ECOFIN, on 'Improving the Implementation of the Stability and Growth Pact'. This document offers what appears to be a political compromise on what to do with countries in excessive deficit since it contains language that justifies lenience but also contains language on the need to become tougher during good times.

However, on closer scrutiny this seemingly even-handedness is deceptive. ECOFIN (and now also the European Council) are proposing to change the legal texts that make up the SGP only in the direction of leniency; either to give countries an excuse to maintain a high deficit, e.g. the so-called 'all other relevant factors' clause, or to give countries more time in which to adjust. By contrast, no change in the legal texts is called for in the two areas where the Pact was supposedly made more stringent: the expectation that good times would be used to prepare for bad times and the warning of the need to take debt levels into account. The most convincing criticism from economists had concerned these two points: ideally the SGP should foster adjustment during good times, and countries with high debt levels should be even more cautious in running deficits. ECOFIN has decided that nothing should be done on these two points. By failing to improve the preventive arm of the SGP, it has sown the seeds of its own future failure. When the next slowdown comes, countries whose fiscal position is still unsound will again brand the SGP as irrational.

Another justification given for the reform of the SGP had been that one needed to increase national 'ownership'. Instead of punishing member countries for their misbehaviour they should be helped to find on their own how to reign in their deficits. However, there has already been a test of the value of 'ownership'. The case of Germany is a good example. In early 2003 the Council noted that

> "Whereas the German government adopted a federal budget aiming at a general government deficit of 2 ¾% for 2003; whereas on 18 December, the German government adopted an updated Stability Programme aiming at a balanced budget in 2006 in a central scenario. " (See below for the exact source.)

The outcome is well known: in 2003 the actual deficit was considerably above 3 % of GDP and the balanced budget projections for 2006 have disappeared. It is now forecast that the deficit for that year will be between 2 and 2.5 %.

A second test of ownership came in November of 2003 when the Council did not follow a Commission recommendation and instead

> "In the light of the Commission Recommendation and the commitments made by Germany, the Council recommends Germany to:
>
> a. achieve in 2004 an annual reduction in the cyclically-adjusted deficit of 0,6 percent of GDP;"

This was a commitment made by the German government (on its own initiative, to show to the Commission that it was serious about fiscal adjustment) and also became a recommendation by the Council. Germany has not kept this commitment. The cyclically adjusted deficit was actually slightly higher in 2004 than in 2003. (The fact that growth was better in 2004 than in 2003 renders this fact even more significant although the commitment had been made in cyclically adjusted terms.)

At the time (in November of 2003)

> "The Council agrees to hold the Excessive Deficit Procedure for Germany in abeyance for the time being. The Council stands ready to take a decision under Article 104(9), on the basis of the Commission Recommendation, should Germany fail to act in accordance with the commitments set out in these conclusions …"

The silence of the Council on this point has been deafening. Although Germany has clearly violated the commitment solemnly made in November of 2003 there has been no follow up. There has been a test of the value of national ownership with the clear result that unilateral commitments are of little value, essentially because the country concerned then also arrogates itself the freedom to interpret this commitment on its own.

All in all this so-called reform of the Stability Pact only increases the room for a more political interpretation, and experience suggests that this room will be mainly used to cater to the short term political expediency of the larger member states.

(Based in part on joint material with Angel Ubide and Thomas Mayer)
The Party is Over :Macroeconomic Policy in the Euro Area after the Demise of the Stability Pact, by Daniel Gros, Thomas Mayer and Angel Ubide.

Annex 2

Council Recommendation in the Context of the Excessive Deficit Procedure for Germany

COUNCIL RECOMMENDATION TO GERMANY

of 21 January 2003

with a view to bringing an end to the situation of an excessive government deficit - Application of Article 104(7) of the Treaty

Whereas the Council has decided, in accordance with Article 104 (6), that an excessive deficit exists in Germany.

Whereas the German government adopted a federal budget aiming at a general government deficit of 2 ¾% for 2003; whereas on 18 December, the German government adopted an updated Stability Programme aiming at a balanced budget in 2006 in a central scenario.

HEREBY RECOMMENDS:

- the German government to put an end to the present excessive deficit situation as rapidly as possible in accordance with Article 3(4) of Council Regulation (EC) No 1467/97;
- the German authorities to implement with resolve their budgetary plans for 2003 which, on the basis of GDP growth projections of 1 ½% in 2003, aim at reducing the general government deficit in 2003 to 2 ¾% of GDP;

In addition, the Council notes the commitments of the German authorities:

- to ensure that the momentum of budgetary consolidation is maintained throughout the period covered by the December 2002 update of the Stability Programme, namely through a reduction in the underlying budgetary deficit by more than 0.5% of GDP per year, ...

Annex 3

Council Conclusions of 25 November 2003

14492/1/03 REV 1 (en) (Presse 320)

2546th Council meeting

- ECONOMIC AND FINANCIAL AFFAIRS -

Brussels, 25 November 2003

IMPLEMENTATION OF THE STABILITY AND GROWTH PACT

2. In the light of the Commission Recommendation and the commitments made by Germany, the Council recommends Germany to:
    a. achieve in 2004 an annual reduction in the cyclically-adjusted deficit of 0,6 percent of GDP;
    b. achieve in 2005 a reduction in the cyclically-adjusted deficit of at least 0,5 percent of GDP or a larger amount so as to ensure that the general government deficit is brought below 3 percent of GDP;
    c. …
    d. ensure that the budgetary consolidation continues in the years after 2005, namely through a steady reduction in the cyclically-adjusted budgetary deficit by at least 0,5 percentage points of GDP per year or more if necessary to achieve the medium term position of government finances close to balance or in surplus and bring back the debt ratio to a declining path;
    e. put an end to the present excessive deficit situation as rapidly as possible and at the latest by 2005.
3. In the light of the recommendations and the commitments by Germany set out above, the Council decided not to act, at this point in time, on the basis of the Commission Recommendation for a Council decision under Article 104(9).
4. The Council agrees to hold the Excessive Deficit Procedure for Germany in abeyance for the time being. The Council stands ready to take a decision under Article 104(9), on the basis of the Commission Recommendation, should Germany fail to act in accordance with the commitments set out in these conclusions …

Opinion on the Reform of the SGP

Briefing Paper for the Monetary Dialogue of May 2005 by the Committee on Economic and Monetary Affairs of the European Parliament with the President of the European Central Bank

Gustav A. Horn

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Executive Summary

In March the European Council made a proposal on an improved implementation of the Stability and Growth Pact (SGP). The reason why the Council had to change existing rules is that the SGP simply did not work as expected. The most important advantage of the Councils decision to reform the SGP is that it implies a more flexible assessment of the 3 % threshold. However the reform does not correct a major constructional failure already part of the SGP. While there still are fairly strict and precise rules on what to do when at economically bad times the deficit be-comes excessive, there are no restrictions for good times. Hence the asymmetry of SGP rules prevails. The only difference to the previous situation is that the mechanical interpretation of margins has been removed and replaced by more economic considerations. It would have been preferable if the reform would have been more systematic.

1. The Proposal of the Council

On March 20 the European Council made a proposal on an improved implementation of the Stability and Growth Pact (SGP). The reason why the Council had to change existing rules is that the SGP simply did not work as expected. All major member countries like France, Germany and supposedly Italy of the Euro area showed excessive deficits according to the prevailing rules and were unable to reduce them below the reference value. Hence the council had to make up his mind either applying the fines as defined by the SGP in case of non compliance or change the rules.

While the former suggestion was seen by many scholars as recommendable to preserve the credibility of SGP, others advocated strongly for the latter in order to make the SGP really working. The Council has decided to follow the latter option that shall be outlined in this section.

The main intention of the Council is to enrich the "common framework with a stronger emphasis on economic rationale of its rules." (European Council (2005), p.3). Thereby credibility and ownership of the SGP should be improved. One of the most important parts of the suggestion is that a deviation from the Medium Term Objective (MTO), i.e . a budget close to balance or in surplus and a debt burden below 60% of GDP, or a trespassing of the reference value of 3 % should be interpreted against the backdrop of other economic variables. Among them special attention should be paid to pension reforms that introduce a multi pillar system including a mandatory fully funded pillar. This kind of measure is expected to reduce the implicit debt burden originating from demographic changes straining the financial means of pay as you go social security systems.

As far as the introduction of such a pillar creates costs, short term deviations from the adjustment path to MTO or the MTO itself will be accepted. Furthermore it should be taken into consideration whether the deficit exceeds government investment expenditure. As long as the deficit does not do so, the future revenues of today's investment may finance the deficit, such that no long term indebtness is involved. It also should be considered whether the excessive deficit is the result of wrong forecasts rather than wrong policy. In the former case the government cannot be hold responsible and should not be punished. Another reason for deviations to be considered when assesing excessive deficits by the Council is that the debt burden is still below the reference value of 60%. Then a temporary rise of the deficit does not destroy the sustainability of public finances. In a further step the deficit criterion is connected to the Lisbon strategy. All costs caused by measures in the framework of the Lisbon strategy are allowed to raise the deficit temporarily. The argument is basically the same as in the case of investment. By raising potential growth future revenues can cover present deficits. Finally, the Council accepts that a deficit reduction strategy starts one year after the excessive deficit has been detected, usually almost two years after its occurrence. That gives enough time to the government to set up a proper consolidation strategy. Furthermore it is expected that any economic weakness that may have caused the high deficits has been overcome until such a consolidation strategy becomes effective.

2. The Pros of the Councils Decision

The most important advantage of the Councils decision is that it implies a more flexible assessment of the 3 % threshold. It was stupid indeed to fix such a margin without almost any qualifications. That has been changed now and a number of considerations are now necessary before declaring a deficit value above 3 % as excessive. Before 1992 when the Maastricht treaty was sealed there was no economic theory that said deficits should always be lower than 3 % or the debt burden should always be below 60 %. In fact these conditions were set as a self commitment based on average figures on the debt ratio in potential member countries of the currency union at that time. The 3 % threshold was derived from the 60 % mar-gin by assuming a 5 % average nominal GDP growth in the Euro area. Then a 3 % deficit reflects a 60 % debt ratio in the long run and any trespassing of the 3 % would raise the long term debt ratio. In the meantime this relationship has broken down since nominal growth in the Euro area was on average below 5 %. Consequently either the deficit margin would have been lowered or the allowed debt ratio to be increased in order to regain consistency between both values. Another way out, gone by the Council, is to interpret these criteria more flexible. On the one hand then the self commitment is not kept and this may hamper the credibility of the consolidation process. On the other hand the past has shown that the commitment could not be kept without severe damage to the respective economies and it therefore simply had to be changed in order to be credibly applied.

How important that is shows the debt burden condition. If the debt ratio to GDP is well below 60% there is no danger financial sustainability according to the criterion of the SGP even the deficit is above 3 %, as long as this is the case only temporarily. Hence the Council just has to check whether the financial strain is really just temporarily and the debt ratio stays below 60 %. Also the delay between the occurrence of a deficit and the beginning of a consolidation strategy could prove stabilising, since it diminishes the risk of a destabilizing pro-cyclical fiscal policy. This correct point is even made explicitly by the Council when stating that governments should “use more effectively periods when economies are growing above trend for budgetary consolidation in order to avoid pro-cyclical policies” (European Council (2005), p.4).

It is also important to stress the role of wrong forecasts. In Germany but also in other countries like Italy forecasts not just by governments but also by professional forecasters tended to be overly optimistic during recent years. As a consequence consolidation plans were based on too optimistic assessments of tax revenues and social spending. In addition to that a lower than expected GDP increases the debt ratio already by definition. A mechanical treatment of the 3 % margin would not take into consideration that the government cannot be hold responsible for wrong forecasts, especially not if these forecasts previously were considered as sound by the Commission.

3. The Cons of the Councils Decision

While acknowledging above mentioned advantages of SGP reform there are nevertheless some serious shortcomings. One refers to the treatment of reform costs. In particular an introduction of a fully funded social security system is seen as a reason to deviate from MTO or to trespass the 3 % margin. This is based on the assumption a fully funded system reduces future costs of social security for governments. This is by far not guaranteed. Fully funded systems increase the incentives to save for private households, especially if supported by public subsidies. 5

Higher private saving by definition means lower consumption and thus money is drawn out of the economic system leading ceteris paribus to lower growth. In turn there is less money to save such that the overall effect on aggregate savings is far from clear. Furthermore if the economy enters a lower growth path, future pensions will be lower if the income distribution between the active and retired population is not changed. Given that, there is no reason to assume that these reforms save future costs.

A more important point refers to the silence of the proposal on what should be done at times when growth is above trend. Apart from the fairly general statement cited above there is still no rule to be observed. Thus the reform does not correct a major constructional failure already part of the SGP. While there were and still are to some extent fairly strict and precise rules on what to do when at economically bad times the deficit becomes excessive, there are no restrictions for good times. Then the deficit may be low, but the debt burden may still be too high to deal with a downturn without trespassing the margins. Hence the asymmetry of SGP rules prevails. But that is exactly time when usually major mistakes are committed with respect to budget consolidations. If there is plenty of money available from high tax revenues, governments tend to spend it rather than to use it for a significant reduction of a debt burden. The only difference to the previous situation is that the mechanical interpretation of margins has been removed and replaced by more economic considerations.

4. What should have been done

It would have been preferable if the reform would have been more systematic. One suggestion in that respect is the introduction of expenditure rules to achieve a sustainable budget position. If all non cyclical and non investment expenditures have to follow a predetermined path that given a certain trend growth would lead to consolidation, then there are in particular restrictions for spending at good times. Then governments are forced to use high tax revenues for consolidation. That would have been an appropriate answer to problems created by the previous version of the SGP.

Reference

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Topic 2

Fiscal indiscipline: why no reaction yet by the markets?

Unsound fiscal policies and financial markets discipline

Briefing Paper for the Monetary Dialogue of May 2005 by the Committee on Economic and Monetary Affairs of the European Parliament with the President of the European Central Bank

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There is a general perception about the apparent lack of discipline that financial markets impose to the Euro Area member countries that are following unsound or excessive fiscal policies and are not meeting Maastricht and Stability and Growth Pact (SGP) targets. This perception is not new, there are some economists who think that one of the arguments used for introducing the SGP was the recognition that the financial markets were not imposing enough discipline on those member countries following unsound fiscal policies, and, therefore, it was necessary to achieve a Pact among Member States to agree on fiscal targets to be met and on sanctions to be imposed to fiscal profligate members not meeting them.

Nevertheless, in my opinion this perception does not fit reality. The origin of the SGP is mainly the following: before EMU, each fiscally irresponsible member country was alone bearing the full financial consequences of its budgetary laxity and its bond yields and borrowing costs were going up. After EMU, as fiscal policies are remaining a matter of national governments, the higher borrowing costs of one irresponsible member country are partly shared by the whole Euro Area, through negative spillovers, therefore, some kind of fiscal coordination and hence some kind of shared responsibility for the Euro Area creditworthiness becomes necessary. This is the main argument behind the SGP. I will try to explain the reasons why the discipline imposed by financial markets is less hard than it was used to be before and why it is a much more complex issue than what it looks at first sight.

Financial markets punish unsound fiscal policies, but much less in developed countries

Long-term interest rates are among the majors determinants of the cost of capital. In the Euro Area countries, the overall level of long-term interest rates depends in turn largely on the rates paid on government bonds, which have the highest weight on the overall stock of long-term bonds issued. The fact that long-term nominal and real interest rates in the Euro Area have been coming down since the early 1980s and that today are half the rate than in the 1970s and 1980s is a consequence of falling inflation and convergence of bond yields of countries with a past history of high inflation (Italy, Spain, Greece and Portugal) towards the German bond rates bench mark and, as a consequence, of an upward revision in debt ratings for several countries (Ireland, Italy, Spain, Finland and Portugal). Both these tendencies are the result of a successful EMU implementation which has tend to benefit most to the more previously profligate members. (Dhantine, Giavazzi and Von Thadden, 2000), (Codogno, Favero and Missale, 2003)

The reduction first and disappearance later of exchange risk premia translated into a considerable reduction of interest rate spreads, especially for member countries previously prone to high inflation and frequent devaluations. But, cross-country real interest rate differentials have persisted, mainly explained by different credit and liquidity risk. The behavior of public finances have continued to be relevant in explaining developments in long-term interest rates and therefore of the cost of capital in Euro Area countries.

Most research done about the impact of developed country expansionary fiscal policies on long term interest rates show that agents and markets play a role, albeit not very large, in disciplining profligate governments. Using a broad panel of 16 OECD countries, covering the period 1960-2002, Ardagna, Caselli and Lane (2004) show that a one percentage point increase in the primary deficit-to-GDP ratio is associated with a 10 basis points rise in the nominal interest rate on 10-year government bonds. The increase is larger when one also considers the effect that a shock to the primary deficit has on expected future fiscal policy and macro variables in the long-run. That is, using a dynamic VAR, a one percentage point increase in the primary deficit-to-GDP ratio leads to a cumulative increase of almost 150 basis points after 10 years.

In addition to the current deficit, it is also very important to examine the implications of changes in the stock of public debt on long-term interest rates. The authors find that the effect is non-linear and that the response of long term interest rates is positive and statistically significant only when the stock of public debt is above a given threshold. While for a OECD country with the debt-to-GDP ratio of 119 per cent (Italy in 2002), a one-standard-deviation increase in government debt leads to an increase in the nominal interest rate on 10-year government bonds of about 36 basis points, an increase by the same amount in a country with a debt-to-GDP ratio of 58 per cent (the US in 2002) leads to a 5 basis points "decrease" in the nominal interest rate on 10-year bonds. It is important to note, however, that the ratio of public debt to GDP has a standard deviation (the geometric mean of the deviations) equal to 26 per cent hence a one-standard-deviation increase in the public debt is a substantial change. Therefore, the response of interest rates to a one percent change in the stock of public debt to GDP ratio would be minimal, even in OECD countries with very low and very high values of public debt. They also find that, due to financial globalization, the worsening of public finances abroad has an effect on national interest rates, which is evidence that OECD countries' financial markets are, to some extent, internationally integrated.

Gale and Orszag (2003) have conducted a similar analysis for the US and they find out that when taking into account expected future deficits the evidence of the impact of budget deficits on long-term interest rates becomes clearer. The authors conclude that a projected rise in the US budget deficit of 1 per cent of GDP raises long-term interest rates by 0.4 to 0.6 percentage points after one year and a full point after ten years.

Similar results are found by Garzarelli (2004). He shows for the Euro Area that the reaction of markets to the fiscal or position of Member States show that deficits (the "flow" measure of the position) are better at explaining the variance of bond yield than any "stock" measure of indebtedness. A 1 per cent of GDP increase in the budget deficit has more immediate and larger upward impact on longer-dated bond yields that an equivalent increase in the debt-to-GDP ratio, when the contrary should expected to be the case. According to him, this paradoxical divergence is even more striking when the comparison is made in terms of "cyclical-adjusted" relative fiscal positions, where budgetary positions have an even larger effect on longer-term bond yields that debt levels.

The theory shows that efficient financial markets are likely to react to expected rather than actual deficits. The reason is that expectations of higher future deficits will consistently translate into expectations of lower aggregate savings and increased interest rates and, according to the expectation theory of the term structure of interest rates (Rendu de Lindt and Stolin (2003) they would, in turn, produce a steepening of the yield curve, that is, an immediate increase of the spread between long and short term bonds, because arbitrage in the bond markets will equate returns on long-term bonds with average expected future returns on short-term bonds.

Since the expectations of interest rates are, to a large extent, driven by the perception of economic agents on cyclical developments, the empirical work done at the European Commission (2004) for the Euro Area, for the period 1990-2002, includes the output-gap as a further explanatory factor for the interest spread, together with the following other factors: the present budget balance, a one year ahead budget balance forecast, another three years ahead cyclically adjusted budget balance forecast, a constant term and, to account for a possible impact of different institutional regimes, two dummies for the two previous EMU phases, I and II, are also included. The results show that these explanatory factors account for around 40 per cent of the variance in interest rate spreads and that the impact of an additional 1 percentage point of GDP budget deficit increases the interest spread between long-term and short-term bonds by about 15 to 20 basis points.

Finally, Caballero and Krishnamurthy (2004) try to find an explanation for the very distinct discipline imposed by financial markets on countries like Belgium and Italy (pre-Maastricht), which run large fiscal deficits and accumulate debts far beyond those of Argentina, without experiencing crises as dramatic as that of Argentina. Their explanation is what they called "financial depth". For that they mean the supply of funds available to the government of an emerging market. Investing in emerging markets requires far more expertise than investing in developed ones. It entails knowledge of political risk, exchange rate risk and the degree of institutional judicial and government quality and security. Therefore, to be an investor in those countries needs a high level of local knowledge and specialization.

Given that government expenditure tends to crowd-out private investment, expansive fiscal policy may in fact have a contraction effect on economic activity. The crowding-out problem is amplified if expansionary policy worsens the quality of the country's assets, through two channels: First, as the rising of share of public debt to private assets reduces the aggregate liquidity of the country's assets, specialized investors increase their required liquidity premium and this further reduces financial depth. Second, if the lack of fiscal discipline sparks investors' fears regarding the fiscal responsibility of the government, specialized investors endogenously lower their valuation of the country's assets and financial depth is reduced further. They find out that this effect is much larger in emerging economies and that the response both in crises and in tranquil times is much more negative in emerging economies than in advanced ones.

Reasons for Spreads Compression in the Euro Area

The continuous trend of narrowing inter-country spreads and tightening of swap spreads in the Euro Area has, first of all, a cyclical component, which is perfectly understandable. Most empirical research carried out on this issue shows that spreads tend to narrow when short rates fall, when the slope of the yield curve gets steeper and when the relative supply of government bonds increases. Spread compression has been further underpinned by the strategic asset allocation shifts out of equities into fixed income and credit products, which followed the burst of the “equity bubble” in 2001. Another cyclical component is the present large appreciation of the Euro versus other currencies, made possible for an increasing appetite from worldwide investors to diversify into euro assets, which has also tended to compress government spreads in the Euro Area. (Garzarelli, 2003)

There are also structural underlying forces that tend to narrow and compress spreads, derived from the successful implementation of EMU and the introduction of the Euro. On the one side, tighter market integration and greater cross-country substitutability of government debt instruments have added more structural and lasting dimension to the compression of spreads. The removal of the exchange rate risk following the introduction of the euro has led to greater integration of government bond markets among Euro Area member States. The Euro Area debt market is now regarded as a largely homogeneous market with close “fungibility” across debt securities issued by different sovereign borrowers. Non resident holdings of government bonds issued by countries such as France, Italy and Spain have almost doubled and have also increased in other smaller countries, such as Belgium, the Netherlands and Portugal. By contrast, the share of government debt owned by non-residents in Germany has tended keep steady or to fall slightly.

The homogeneity and efficiency of the Euro Area’s government bond market is also testified by only very small differences in the financing rates for different collaterals in the securities repo market. The main fragmentation of the market comes from differences in the fiscal, institutional and regulatory framework in each country and by the “home bias” in demand. With the passage of time these different regulations and tax treatment to Euro Area investors will tend to disappear, making the securities markets even more integrated and less fragmented. (Garzarelli, 2003)

On the other side, a number of developments have also contributed to this increasing compression of spreads. In the absence of a supranational issuer, individual sovereign borrowers have pursued competitive issuance strategies centered in “carving out” niches along the term structure of interest rates. The publication of regular auction calendars and the announcement of debt management targets have increased market transparency. New debt instruments have been launched and issuance activity has become more concentrated and larger in size. Meanwhile, smaller issuers have resorted to syndication procedures allowing them to reach a broader set of investors.

Moreover, the market has developed pan-European electronic exchanges for debt securities, such as Euro MTS, Broker Tec and E-speed in addition to customer execution platforms such as Trade Web, which have greatly improved the depth and liquidity of the market as well as the price discovery. These developments have made possible for other Euro Area members to compete with lower yielding German bunds. Nevertheless, Germany’s role as a pricing reference for the Euro Area bond market continue to be very relevant because of the existence of future contracts at the 10, 5 and 2 year maturities with an underlying basket of German-only-deliverable securities. The attempts to established multi-issuer deliverable contracts have not yet been successful, but it will eventually happen, in the near future, adding to the present compression trend.

There is also another important factor. With increasing globalization and integration of international financial markets there is always liquidity and appetite available, somewhere in the world, to diversify risk and to invest in euros as the best alternative to dollars given that both currencies tend to be fully uncorrelated. When choosing among the Euro Area government risks, many of them prefer to invest in government debt securities of countries with a few basis points higher yields than those of Germany, knowing that their probability of default is zero, that Germany's prospects are no better than those of other members, that the financing costs are the same and that there is enough market liquidity available.

Finally, there are two other important elements affecting spreads compression. One is that, in some countries of the Euro Area, a proportion of their debt is hold by a small number of domestic banks and is seldom traded in the market. Governments have no interest in those banks diversifying because they act as useful captive repository of their debt and banks do not seem to be worried by holding it. Why? Because it is very easy for those banks to offload these bonds to the ECB, since they are allowed to offer to the ECB any Euro Area government debt security, irrespectively of its credit rating, as collateral in its weekly open market operations, through which the ECB provides the banking system with liquidity.

Market discrimination among Euro Area Member States securities may increase in the future

It is important to underlie that the assessment of relative credit risk should be an important factor determining spreads in EMU, for two main reasons: on the one side, exchange rate risk has been eliminated with the euro introduction and on the other one it is not possible for Member Countries in EMU to have ultimate recourse to "printing money", meaning that more attention should be paid to the sustainability of public finances. The "no bail out" clause in article 103 of the EU Treaty means that it is still important to focus on developments in each individual country.

Nevertheless, a default by any Member State is today inconceivable by the financial markets, and as a consequence, that risk may not be such an important determinant of cross country sovereign spreads. However, investors do require compensation for the mark-to-market risk associated with the higher spread volatility of the weaker sovereign credits and country specific fiscal developments should still matter in the Euro Area. But, today, most Euro area Member States have reached a triple-A rating by at least one of the three major rating agencies and even the lowest rated countries, such as Greece, have shown a tendency to improving it, but, lately some member countries have touched bottom and are showing a deterioration of their relative long term bond yields against the German benchmark.

Euro Area 10 year government bond yield spreads versus the German benchmark have been narrowing in most member countries between May 1999 and May 2005 but some of them have increased in the last year or two. Spain's 10 year bonds have reduced their spread from 26 to 0.03 bp over that period, but their lowest spread was reached at the end of 2003 with 0.00 bp; France's ones have come down from 0.12 to 0.05 bp but they are above their bottom of 0.01 bp reached in the middle of 2003; Italy's narrowed from 0.23 to 0.17 bp, although they have been going up from their lowest 0.10 bp in mid 2003; the Netherlands' bond yield spreads have come down from 0.16 to -0.02 bp; Ireland's one from 0.24 to 0.08 bp, although their lowest spread was reached in mid 2003 with -0.01 bp; Portugal's have gone up from 0.26 to 0.30 bp, before going down to 0.08 bp in September 2004; Greece's have come down from 1.94 to 0.14 bp in mid 2003 and then have gone up to 0.27 bp today. Belgium's have gone down from 0.27 to 0.01 bp at the end of 2004 and then up to 0.11 bp today; Austria's

have been going down from 0.16 to -0.01 bp today and finally, Finland's have gone down from 0.21 to 0.01 bp today. Therefore, there has been a recent relative tiny deterioration of spreads for Spain, France, and Ireland, and a slightly larger one for Italy, Portugal, Greece and Belgium, what is consistent, in most cases, with changes in their fiscal stances and also with the general trend of their credit perception by financial markets. Nevertheless these series of bond yield differentials are not interpolated at the same maturity, thus, small errors could be found.

A similarly small discrimination of government credits by financial markets can be found through the Credit Default Swaps (CDS) market. Some large countries as Italy and small ones as Greece have shown, in recent moths, a slight relative deterioration of their spreads versus other member countries. Italian bonds has increased their spreads versus the benchmark 5 year bond, since September 2004 until today, by 2.5 basis points, Ireland bonds by 2 basis points since February 2005, Greece bonds by 3 basis points since January 2005, Belgium and Portugal by 0.5 basis points since December 2004 and German bonds by 0.3 basis points. The problem with the CDS market is that its liquidity is not large and sometimes does not reflect properly changes in the underlying security. This issue is more common in government securities than in corporate ones.

Moreover, some recent stance changes in the rating agencies may show that ratings may also change in the same direction. For instance, Standard & Poor's (2005) has recently made a very serious warning to some Euro Area countries (France, Germany and Italy) about the lack of long-term sustainability of their Social Security systems because of their fast aging population trends. According to its report, without further adjustment either in their fiscal stance or in their social security and health costs these countries general government debt to GDP ratios will surpass the 200 percent mark by the middle of the century and their ratings will fall from the present triple-A to below triple-B, that is, their rating will lose their "investment grade" status and their bond issues will be considered by the markets as "speculative bonds" similar to those of some developing countries today. The same empirics and results can be made and found in other Euro Area member countries not considered in this analysis.

A second argument for the increasing role of financial markets disciplining unsound fiscal policies is the expansive fiscal effect that may have the recent "relaxation" of the SGP. Given that governments have chosen the easiest way to fulfill the SGP by relaxing it further, financial markets may take a harder line in discriminating by credit risk and hence increasing the cost of long-term capital to some member countries. The SGP had already suffered a major blow when some of some of the large Euro Area member countries decided not to fulfill their targets, which, paradoxically, were imposed at its origin to punish some peripheral members with a bad fiscal discipline track record. The recent measures taken to introduce more flexibility in the items that should be taken into account when calculating the annual level of budget deficits give a larger role to the markets to take their own views about each country fiscal performance, even more if they take into account that this further relaxation of the SGP will make much more difficult for many Euro Area governments to deal with the fiscal burden of ageing populations in the future and would tend to undermine their bond ratings in the long run.

Finally, there is an increasing debate about the role that the ECB can play to stimulate the market discipline impose to profligate countries. Munchau (2005) and Fels (2005) think that the ECB can play a large role in disciplining governments by discriminating, either according to its internal bond rating or to the rating agencies ratings, the bonds that it accepts every week as collateral for its open market operations in order to provide liquidity to the banking system of the Euro Area. The ECB has a powerful tool to do so if it thinks that the SGP relaxation has gone too far and can interfere with its prudent management of interest rates to keep inflation under control. Although being totally independent from government interference, the ECB until now has chosen not to do so because in its statutes, there is no reference to being a "fiscal policeman" of the Euro Area governments. Nevertheless, it could decide to discriminate it thinks that it will help its monetary policy to be more efficient and to reduce the large liquidity that today is present in the money and credit markets. To discriminate according to risk the collateral presented by banks to obtain liquidity may be a more efficient and rational option for the ECB than to raise interest rates instead, given the extremely slow recovery of the Euro Area economy.

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Fiscal Indiscipline: Why no reaction yet by the markets?

Briefing Paper for the Monetary Dialogue of May 2005 by the Committee on Economic and Monetary Affairs of the European Parliament with the President of the European Central Bank

Jean-Paul Fitoussi

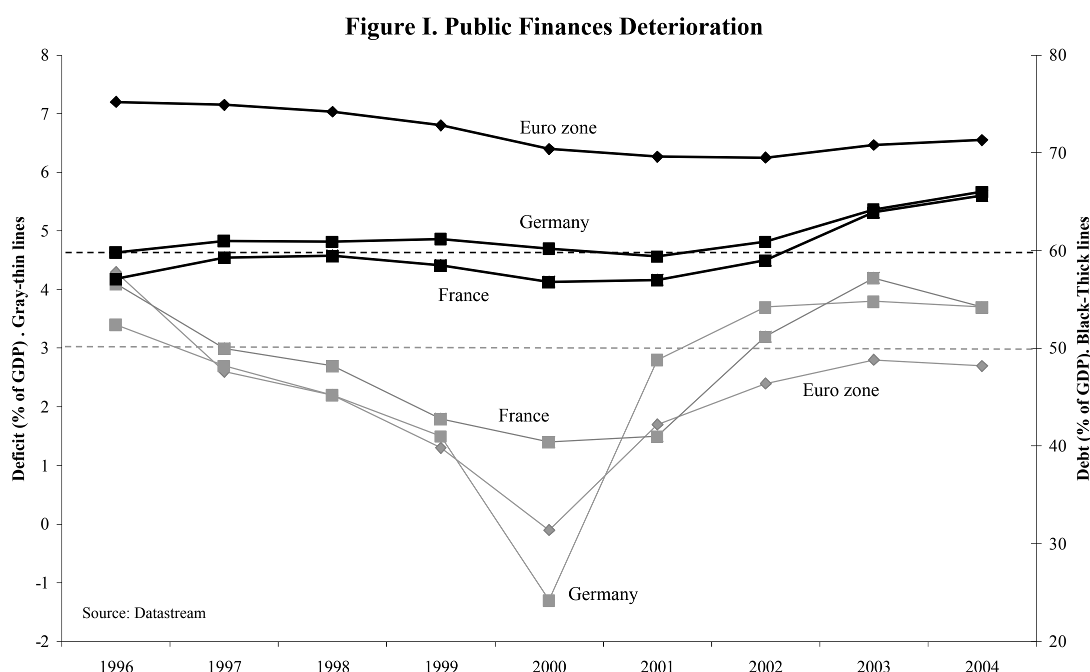
Executive Summary

Two stylized facts emerge as we observe the evolution of public finances in the past few years. The first is a general trend towards a deterioration of fiscal positions, mainly due to cyclical factors (the persistently deceiving growth performance of the Euro zone). The second, a remarkable lack of reaction of financial markets (long term rates) to this deterioration. This is a puzzling set of findings, as the theory tells us that long term rates should react to larger deficits either because they indicate future tightening of monetary policy, or because they require a risk premium. A first explanation of this puzzle is straightforward: markets have perceived the system as well designed in spite of the latest development and hence did not react to the worsening of fiscal position, seen as temporary and harmless; such an interpretation nevertheless may be dismissed on the ground that if the system was perceived as good and well functioning, its very recent modification (March 2005) should have triggered a negative reaction that until now did not materialize. A more convincing explanation recognizes that markets do not focus on public finances alone, but look at more general conditions concerning Saving and Investment. With such a global perspective in mind, long term sustainability does not seem more at risk today than it were a few years ago; hence, the lack of reaction of markets is all but paradoxical, but may simply reflect the lack of credibility of the current formal fiscal framework for Europe.

Introduction. A generalized deterioration of Fiscal Positions in the EMU.

The first five years of this decade have seen a general trend towards a deterioration of public finances in the Euro zone, and notably in the largest countries (Germany and France, but also Italy). Figure I shows that both debt and deficit, for France and Germany, have been above the Maastricht reference values since 2002. A number of smaller countries have seen their finances deteriorate as well, and the euro zone average is close to the limit.
The main explanation of this deterioration is the prolonged slowdown of the European economy. While the US quickly recovered from the 2001 recession, Europe got trapped in a period of slow growth, characterized by inertia in the conduct of both monetary and fiscal policies.

Figure I. Public Finances Deterioration



The fact that Germany and France were among the countries breaching the limits has given an important political impulse to the discussion of the reform of the current fiscal framework for the European Monetary Union, that after a sometimes confuse process yielded the reform approved by the Council in March 2005. The reformed Stability Pact should be more flexible, and should take into consideration country specific factors in the assessment of fiscal discipline. Quite interestingly for our purposes, the "New" Stability Pact has been received with scepticism and concern by the ECB that publicly denounced it as a step towards fiscal relaxation[1].

[1] "Statement of the Governing Council on the ECOFIN Council's report on Improving the implementation of the Stability and Growth Pact". 21 March 2005 (http://www.ecb.int/press/pr/date/2005/html/pr050321.en.html).

The Puzzle of Interest Rates Inertia

Besides the direct effect on the demand of loanable funds, the evolution of public finances, deficit and debt is supposed to affect interest rates through two channels. The first is the variation in country risk that yields an increase in the rates investors demand to hold bonds in their portfolio. Country risk, even if very weak, can explain the persistence of differences in the interest rates we observe in a monetary union. The other channel is the expectation of changes in future monetary policy. Standard theory sees the long term interest rate as the average of expected future short term rates. If the fiscal position deterioration triggers the expectation of a future ECB rate increase aimed at contrasting inflationary pressures, then long rates should also show an upwards tendency. While the empirical evidence on the relationship between debt/deficit and long term rates is mixed[1], the main theoretical channels remain those we just outlined.

If we look at the behaviour of interest rates we can observe a second somehow puzzling fact. The past two years have witnessed increasing turbulence, with the European economies trapped in a low growth – high deficit path, with conflicts among European institutions, with an exhausting debate on the reform of the Stability Pact, and with the general perception of an increasingly lax fiscal stance; thus we have witnessed, at least apparently, a weakening (first *de facto* and then *de iure*) of the fiscal framework for Europe, that should have entailed a sizeable increase of long term rates. Yet, in spite of all these elements, interest rates spreads (that we measure here as the difference between real long term rates of selected European countries and the equivalent in the US) did not react as could be expected, as can be seen in figure II. In fact, we can observe first that since the beginning of 2003 there is no clear upward trend in the spread. (If one looks at the level of interest rates rather than at the spread, one sees that there is no tendency towards an increase in the level of European interest rates; rather the contrary). Then, we can also see that the countries that had more trouble (France and Germany on one side, and Greece on the other) do not show a tendency that contrasts with the average of the Euro zone. The two light grey areas highlight two particular episodes that can be identified as crises. The first is the clash between the Commission and the Council, in November 2003, when the latter refused to follow the recommendation of the former to start an excessive deficit procedure against France and Germany. The second, in the fall 2004, when the frauds regarding Greece's national accounts became public knowledge. In both cases, the evolution of the spreads for the countries concerned was completely in line with the Euro zone average, showing a substantial indifference of the markets for the political and institutional evolution.

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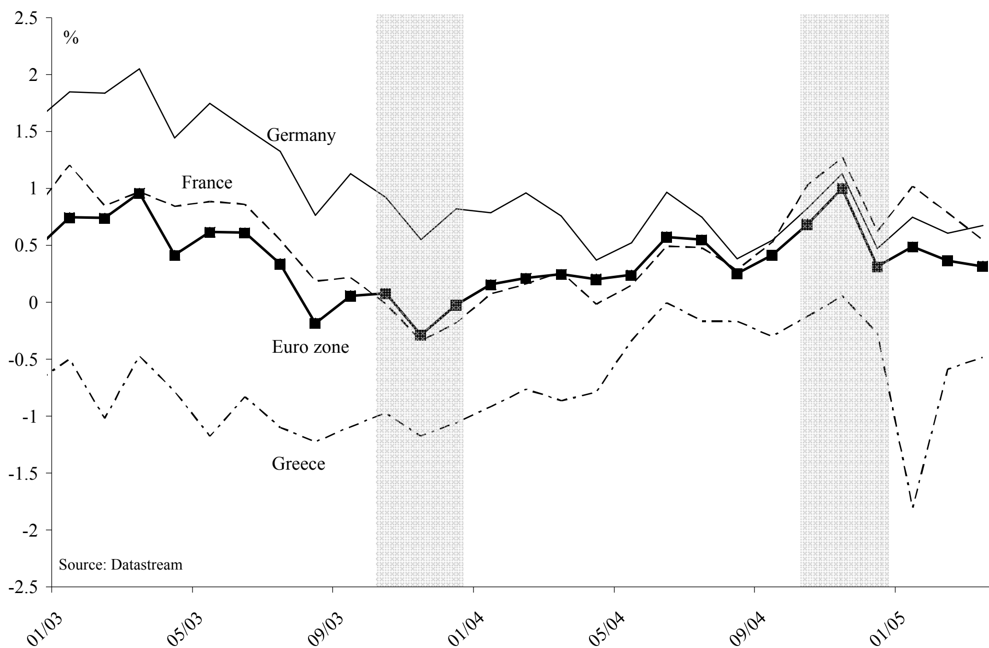
[1] In fact, a great number of other factors may play a role, as the behaviour of private savings, the Ricardian behaviour of consumers, the inflationary effects of public deficit, the distance of the economy from its potential income, and so on. Thus, it is not surprising that empirical analyses are unable to robustly assess the sign of the relationship.

Figure II. Spread on LongTerm (10 Year Government Bonds) Rates



Alternative explanations of the puzzle

The puzzle can be tentatively explained in two different ways. The first is to consider that the SGP has substantially well functioned; in spite of the recent deterioration of public finances, and of the breaching of the 3% limit by the most important countries of the EMU, the use of fiscal policy as a countercyclical tool was negligible. The following table shows cumulated fiscal impulses (i.e. the change in cyclically adjusted budget deficit ratio) since 2000, highlighting a striking difference between the Euro zone on one side, the US and the UK on the other.

Table I. Cumulated fiscal impulses

	2000	*2001*	*2002*	*2003*	*2004*
Euro Zone	0.5	0.9	1.0	0.6	0.6
UK	0.2	0.8	2.9	4.5	4.6
USA	-0.7	0.7	3.9	4.7	5.0
Japan	0.6	-1.1	0.1	0.2	-0.4

Source: OFCE

Not only, the cumulated impulse is about 0.5 per cent of GDP, but it went down, between 2002 and 2003, (of 0.4 points, from 1.0 to 0.6), denoting a mildly procyclical fiscal policy in the Euro area. Thus the table shows that if the SGP was breached *de iure*, it was *de facto* very effective in constraining fiscal policy. If this is the case, and if markets perceived this adherence to the fiscal framework as credible and good, then it is no surprise that long term rates did not move during this turbulent period: the deterioration of public finances has simply to be attributed to cyclical factors, with a very "responsible" behaviour of fiscal authorities as far as the sustainability of public finances is concerned.

But this interpretation encounters a problem once we dig deeper into the events. If the interest rate inertia could be explained by a substantial adherence of governments to a rule perceived by markets as good, then, we should have observed a change of attitude of markets once the debate on the pact headed towards a reform supposed to substantially slacken the constraints. In other words, if markets had trust in the old framework, they should have reacted negatively to its modification. This is what was hinted by the ECB governing council in the statement we cited above, but until now there is not trace of such a reaction.

We can then advance a second line of interpretation, based on the recognition that markets have a broader perspective than to simply focus on public sector debt. Then, we can observe that in the past few years the increase of deficits has been matched by an increase in private savings, due to the "quasi-stagnation" of the economy. The increase of private savings, together with the cyclical nature of public deficits, reduced the possibility of a textbook type crowding out of private expenditure. In fact, a look at the "critical gap", i.e. at the difference between the real interest rate and the real growth rate, shows that it has been substantially decreasing since the first quarter of 2003, a sign that long term sustainability is not at risk (figure III). Thus, if we take this broad perspective, we can conclude that the long term prospects of public finances are no worse today than they were only a few years ago; they are better, if anything. Then it is no surprise that long term rates did not increase following the latest developments.

This brings us to the more general question of the current European institutions and of their fitness for the scopes set forth in a monetary union.

We argued that from the markets viewpoint, credibility and sustainability of fiscal policy are associated with long term solvency; on the other hand, the framework currently in place in Europe does associate credibility with the respect of quantitative limits. The two notions of credibility coincide only when the quantitative limits are in fact designed to guarantee long term sustainability of public finances, i.e. when the fiscal rule is appropriately designed. When it is not the case, then markets will ignore the respect of the rule, and focus, as happened in Europe, on other factors.

In fact, the SGP blends an excessively strict long term objective (the requirement of a budget "close to balance or in surplus over the cycle" yields in fact a long term tendency towards a zero level of debt), with a monitoring scheme that is based exclusively on short term indicators, as the yearly deficit. As many argue, this mix is too straight a jacket to be credible, as most of the time it would require a procyclical fiscal policy. From a long term perspective, such a policy may be so destabilizing that it may (indirectly) lead to unsustainability. Thus it is not surprising that markets did not react to a revision of the SGP, if they consider the new framework as less destabilizing.

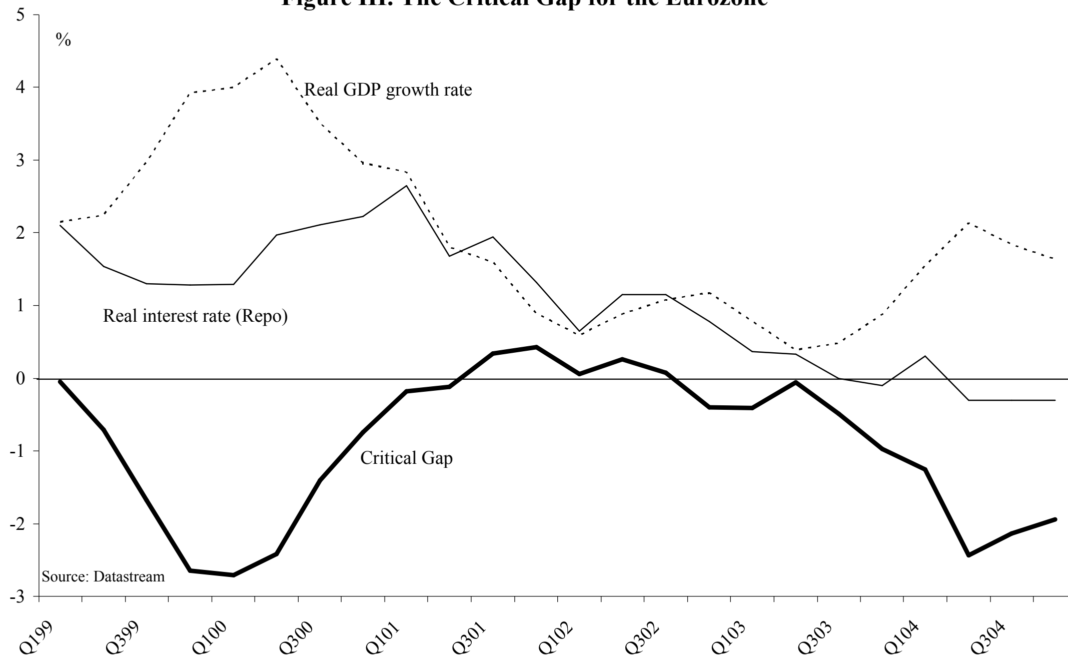


Figure III. The Critical Gap for the Eurozone

The consolidated deficit of the Euro zone has in the recent past been among the lowest of OECD countries (see table II). Furthermore, a number of important structural reforms that significantly reduce implicit government liabilities were put in place by some large European countries. These factors were most likely considered more important in ensuring, long term sustainability, than the widely publicized but substantially unimportant formal infractions to the SGP threshold.

Table II. Budget Deficit as a % of GDP

	2003	*2004*	*2005**	*2006**	*Average 2003-2006*
Euro Zone	2.7	2.9	2.7	2.6	2.7
USA	4.6	4.3	4.0	3.5	4.1
UK	3.3	3.4	3.0	3.0	3.2
Japan	7.7	6.5	6.6	6.4	6.8

**: Forecasts*
Source: National accounts Eurostat and OFCE forecasts

These conclusive remarks also point at a further hypothesis, not necessarily alternative to the previous one. The lack of reaction of markets to the changes in the European fiscal framework may be ascribed to the fact that the change in the rules has done nothing than internalize a change in behaviour that had already been incorporated in market values. This carries the important implication that, being impossible to foresee if and how the new framework will alter the behaviour of governments, it is also very hard to forecast the direction of market changes. In fact, were the applications of the new rules in the next months perceived as allowing more convincing countercyclical fiscal policy, we could even observe a positive reaction of markets. The missing element, in today's Europe is growth, not long term sustainability.

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Executive Summary

There are good reasons why the financial markets have not reacted with alarm to the recent events that concerned the Stability and Growth Pact. They may have rationally considered that the pact was flawed and ineffectual so that its suspension, eventual reform and even de facto demise were non-events, or quite possibly welcome events.

There is some evidence that the markets discriminate between high and low public debts in the euro area. The spreads increase more than proportionately with the size of the debt, a telltale indication of rational discrimination. On the other hand, the effect is quantitatively negligible, which means that markets currently do not exercise any significant disciplinary pressure. It may well be that they are right, that there is no serious risk of state default at this point in time. It may also be a symptom of the often-observed tendency of financial markets to react too late and too much.

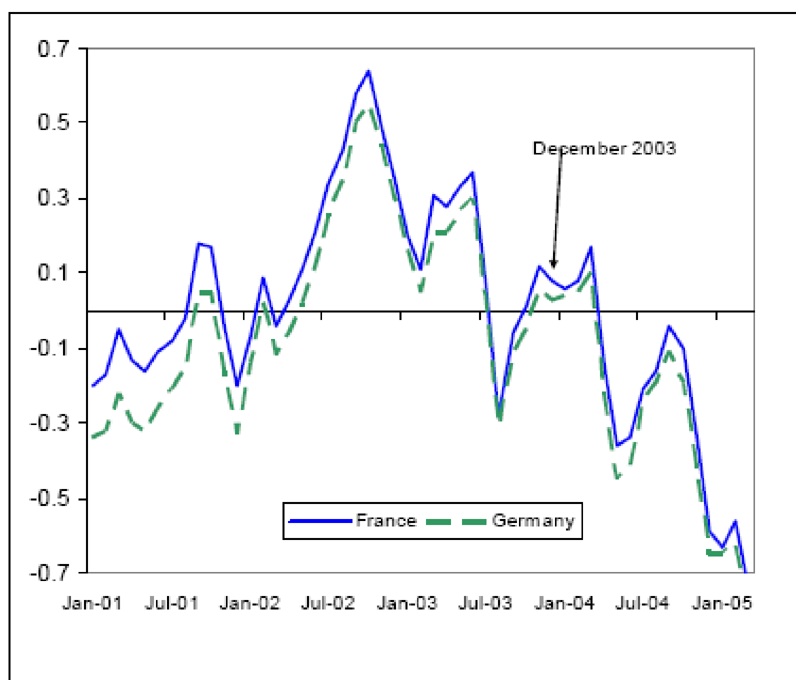
Another possibility is that the Eurosystem's refinancing procedure prevents any effective discrimination among public debts. Indeed, in its market financing procedure, the Eurosystem provides cash to commercial banks against collateral. Collateral takes the form of eligible assets and all Treasury debts issued by EU member countries are accepted. Does this make all Treasury debts look identical to the markets? The answer is negative. The procedure is designed in such a way that ownership of the collateral remains in the hands of the commercial banks so that the Eurosystem does not bear any risk.

The conclusion is that markets do discriminate among public debts but that the effect is very small. It may be entirely rational, after all the probability of default is currently very low, even for the most indebted governments. It may also reflect the fact that markets currently display a low degree of risk aversion. The spreads may grow when risk aversion rises. The may suddenly increase if the markets come to fear default by one government.

1. Five reasons why markets did not react to the decisions of the Stability and Growth Pact

It has been asserted that the Stability and Growth Pact (SGP) is central to the credibility of the monetary union. In this view, any relaxation of the pact would signal the end of fiscal discipline, which would be seriously frowned over by the financial markets. Two events have allowed this hypothesis to be tested: the 24 November 2003 decision to put the SGP in abeyance and the adoption by ECOFIN on 21 March 2005 of a changes that make it significantly more flexible, some even say that the SGP is now *de facto* ineffectual. Figure 1 shows the spreads of French and German benchmark ten-year bond yields over equivalent yields of US treasuries. Since these are monthly averages of daily observations, the relevant observations are those for December 2003 and April 2005, but the latter is not yet posted on the ECB website where the information has been collected. It is quite clear that the financial markets have not considered that French and German bonds have become riskier. If anything, interest rate spreads have moved down. On the surface of it, these events have disproved the view that a rigorous implementation of the SGP is essential for the working of the monetary union. Before jumping to this conclusion, however, we need to pause and examine various alternative interpretations of these events. Five interpretations seem worth considering.

Figure 1. Spreads on ten-year bond rates over similar US bond rates



Source: ECB

(i) The old SGP was neither necessary nor sufficient to promote fiscal discipline. Its suspension and flexibilization are therefore irrelevant, and were treated as such by the financial markets.

(ii) While the weakening of the SGP is potentially dangerous for fiscal discipline, much depends on how the member countries will behave in the years to come. Long term rates have no reason to react strongly to events that are highly uncertain and likely to materialize in the distant future.

(iii) Financial markets are not working efficiently.

(iv) The SGP has not been weakened, it has been clarified and is now more likely to be fully implemented in the future.

(v) The recent events are not telling much about the future because they were the outcome of unusual circumstances – a protracted economic slowdown in France and Germany.

Interpretations (iv) and (v) are plainly not convincing. The Commission has defended (iv) but the formal declaration of the ECB on 21 March 2005 refers to "changes in the corrective arm [that] undermine confidence in the fiscal framework of the European Union and the sustainability of public finances in the euro area Member States". Even if the ECB reaction is somewhat exaggerated, the Commission's benign assessment is n not credible. As for interpretation (v), the present circumstances are obviously painful but not unusual in the sense that they are unlikely to occur again.

In previous Policy Briefs, long before the November 2003 suspension, I have presented arguments in support of interpretation (i). Similarly, I have argued that national fiscal indiscipline is of common concern only to the extent that it leads to defaults that threaten the monetary union. For this reason, recurrent annual budget balances are an inappropriate gauge of fiscal discipline. This is in line with interpretation (ii), which asserts that, while the deficit bias should be glossed over, the financial markets are right to consider that there are better ways to impose fiscal discipline than the SGP. Its demise makes these alternative approaches more likely to be adopted at some point. While, therefore, interpretations (i) and (ii) are plausible, interpretation (iii) deserves more in-depth analysis.

2. Do markets adequately discriminate among high and low debts?

Interpretation (iii) is central to the debate on the need for a SGP. The justification of the SGP must rest on the assumption that markets do not monitor appropriately individual governments. Indeed, if markets operate efficiently, they should impose discipline on governments, as they do on private borrowers, and there is no need for a SGP. A valid concern is that market-imposed discipline occasionally results in bankruptcies; what would the systemic impact of a default by a euro area member government be? The no-bailout clause (art. 103) fully shields other governments or official institutions (the Eurosystem, the Commission).[1] Yet, it is feared that financial markets could mistakenly interpret a default as a threat to the whole euro area; this would be the case if the markets do not adequately distinguish among member governments.

[1] It is sometimes asserted that the no-bailout clause is not water-tight. As far as I know, the reasoning behind this assertion has never been formulated.

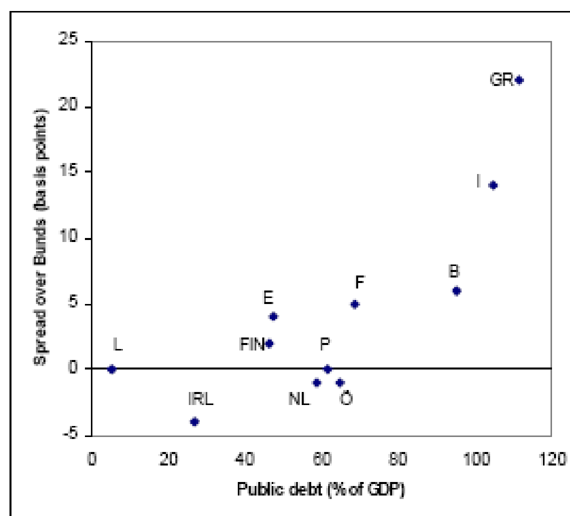
Thus, the key question is whether markets are effectively discriminating among national public debts. The relevant evidence is presented in Figure 2. There is a clear link between the size of government debts and the market-imposed spread on ten-year debt instruments over ten-year German bond rates. Importantly, this relationship is not linear: the spread increased faster the larger is the debt, which is an important requirement for discipline. A simple regression of spreads on debt squared, using the data shown in Figure 2, delivers the following result (t-statistics in brackets):[1]

$$SPREAD = \underset{(2.07)}{-3.716} + \underset{(5.72)}{0.0016}*DEBT^2 \quad (\text{adj. } R^2 = 0.76; DW = 1.72)$$

It is noteworthy that similar studies on federal systems (the US, Canada, Australia) typically find less strong relationships. In particular, they fail to find a more than proportional response of spreads, which is usually seen as an important condition for achieving a discipline effect.

Does this evidence belie the view that the markets are not effectively monitoring euro area governments and fail to impose adequate discipline? Not quite. Figure 3 shows how the estimation indicated above predicts the response of spreads to indebtedness. The shape implies an increasingly steeper response – i.e. more than proportional – but the numbers are small. For instance, a debt increase from 40% to 80% of GDP is found to elicit a spread increase of 8 basis points, a trivial effect. Markets do discriminate among government debts, but too little to impose discipline.

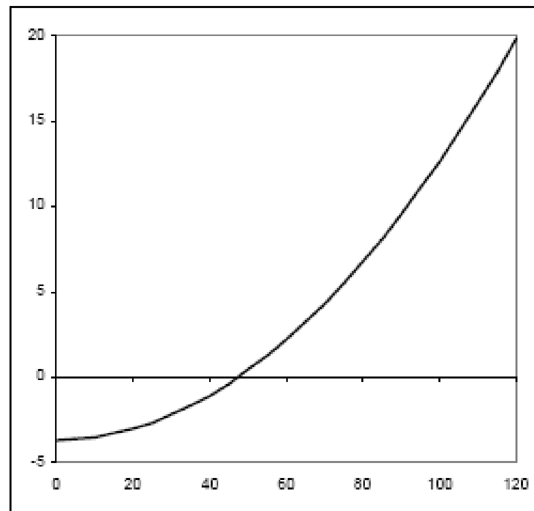
Figure 2. Spreads of ten-year government bond yields over the German Bund yield and gross public debts (Maastricht definition) - 2005



Source: ECB

[1] With eleven observations, this relationship should be taken with prudence.

Figure 3. Estimated relationship between spreads (basis points) and public debts (% of GDP)



Source: author's calculation

3. Four reasons why markets do not discriminate enough among high and low debts

How then can we interpret the fact that markets do discriminate among national public debts but insufficiently so? Four possible interpretations can be advanced.

(i) Markets function adequately. The small spreads reflect the view that, at present time, there is very little risk of default even in the countries where public debts are high

(ii) Markets react too late and too much. They initially fail to notice rising risks and, when they realize that the situation is becoming dangerous, they panic and generate crises.

(iii) European bond markets are insufficiently developed and integrated.

(iv) The Eurosystem's operations in effect prevent markets from adequately pricing public debt risks.

The third interpretation can be rejected. Much evidence has been produced recently to indicate that European public bond markets are well integrated. This market is apparently the only one that has been perfectly unified following the introduction of the euro.

Interpretations (i) and (ii) are not necessarily mutually exclusive. Markets may well consider that the on-going string of sizeable budget deficits in some member countries does not imply in any way the sort of loss of control that could lead to defaults. At the same time, should the situation seriously deteriorates, it cannot be ruled out that the markets will first fail to react and then react too much and too late. Indeed, this is what has repeatedly happened in a number of emerging market countries (Latin America, Russia). Under adverse conditions, the curve shown in Figure 3 could suddenly become much steeper and impose belated discipline on hapless governments.

This combination of early market complacency followed by panic overreaction constitutes a strong argument in favour of some form of disciplinary device. It applies to any country, not just to euro area members, even though it is not an argument for the particular form of the SGP. Interpretation (iv) raises an interesting issue. For its refinancing operations, the Eurosystem provides liquidity to commercial banks either through repos (repurchase agreements), whereby the Eurosystem acquires or sells selected assets in exchange for liquidity, or through collateralized loans, with the same assets used as collateral. Treasury debts are among the most used selected assets. Could it be that the fact that all Treasury debts are admitted by the Eurosystem make them *de facto* equivalent?3 The answer is negative. For repurchase agreements, the Eurosystem's counterparty is committed to buy back the assets at a price agreed in advance. For collateralised, loans, ownership of the collateral remains with the counterparty. In addition, the ,assets that make up the collateral are priced to market daily and the Eurosystem may call for additional deposits in the event that the value of some of these assets decline. 3 A key principle of finance is that assets that always trade at the same price are identical. The conclusion, therefore, is that the monetary policy operations of the Eurosystem cannot affect the market value of Treasury debts. The tiny effects seen in Figure 2 and Figure 3 are only explained by item (i) above: the markets see a very small probability of default. This does not seem irrational at all.

4. Conclusions

On the question why the markets have not reacted to the important events that have affected the SGP, a reasonable answer is that they have behaved appropriately. The weakening of the pact is not a signal of impending fiscal indiscipline. The SGP was poorly designed and had to be adapted. Even though the new pact remains flawed, its weakening may actually be an improvement over its initially rigid and inadequate formulation.

On the question whether markets adequately discriminate among disciplined and undisciplined public borrowers, the answer is that they do discriminate and take account of the size of the debts. The response is feeble at this stage, maybe because the risk is seen as very small, maybe because the risk appetite – the willingness of markets to hold risky assets – is low.

Risk appetite is known to change over time. It is now believed to be high, which can explain why the spreads are negligible. Risk appetite is likely to rise in the future, and spreads will then increase. In addition, markets may eventually see some Treasury debts as seriously risky and react, even possible over-react as has been the case in the past. This may be a disruptive form of discipline, but there is no known cure.

Topic 3

Euro area growth rates versus non euro area

Euro Area Growth Rates versus Non Euro Area

Briefing Paper for the Monetary Dialogue of May 2005 by the Committee on Economic and Monetary Affairs of the European Parliament with the President of the European Central Bank

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1. In the last 15 years growth differentials between the Euro area and the other member countries of the European Union (before May 2004: the former accession countries) have seen a differing pattern. Table 1 shows that in the period between 1991 and 1995 growth in the Euro area was stronger than in Sweden, a little bit weaker than in the United Kingdom and half a percentage point weaker than in Denmark. In second subperiod which includes the years 1996 to 2000 the negative growth differential vis-à-vis the United Kingdom increased and growth was now also weaker than in Sweden. In contrast the differential vis-à-vis Denmark declined. Compared to the new member countries the Euro area had a negative differential of 1.4 percentage points. This overall tendency became more pronounced in the third subperiod within the years 2001 to 2005. Only the growth differential vis-à-vis Denmark declined somewhat.

Table 1: Growth differentials between the Euro area and other EU member countries

	1991-95	1996-00	2001-2005
Euro area minus DK	-0.50	-0.10	-0.14
Euro area minus SE	0.7	-0.60	-0.88
Euro area minus UK	-0.2	-0.60	-1.12
Euro area minus AC10		-1.43	-2.37

Source: European Commission

2. One major explanation for the growing growth differentials between the Euro area and the other EU countries is the very unsatisfactory economic situation in Germany. If one excludes Germany from the Euro area, the differences and their changes over time become much less pronounced. As Table 2 shows, the growth differential vis-à-vis Sweden becomes relatively small for the last two subperiods. In relation to the United Kingdom the growth differential is also reduced and it remains relatively constant over time. The only difference is the growth differential to Denmark which increases in relation to a Euro area excluding Germany. This is due to the very close economic linkages between Denmark and Germany.

In other words, Germany shows an increasing growth differential vis-à-vis the Euro area. While German growth was stronger than in the rest of the Monetary Union in the first subperiod, the German economy fell behind in the second subperiod. In the last five years this negative differential increased further.

Table 2: Growth differentials between the Euro area (excluding Germany) and other EU member countries

	1991-95	1996-00	2001-2005
Euro area ex D minus DK	-0.71	0.23	0.39
Euro area ex D minus SE	0.49	-0.27	-0.35
Euro area ex D minus UK	-0.41	-0.27	-0.59
Euro area ex D minus AC10		-1.10	-1.84
Euro area ex D minus Germany	-0.71	1.13	1.19

Source: European Commission

Thus, stimulating growth in Germany could be regarded as an important contribution to a reduction of the growth differential between the Euro area and other EU member countries. As mentioned in my last briefing paper, Germany currently suffers above all from a lack of domestic demand which is at least partly related to very low wage increases in comparison to the other Euro area member countries. (Table 3). It should be noted that productivity increases were identical in Germany and in the rest of the Euro area in the last two subperiods.

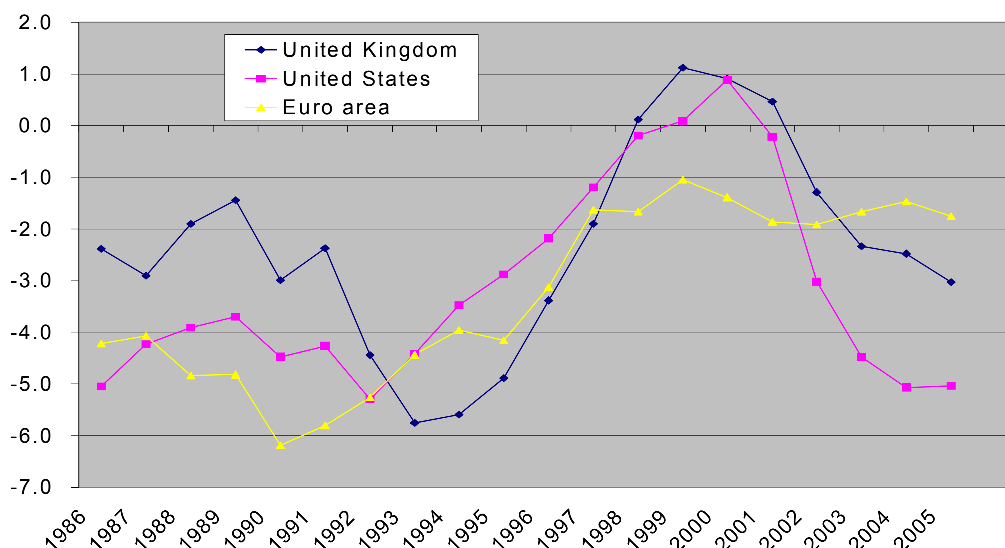
Table 3: Differential in compensation of employees per head and productivity differentials between the Euro area (excluding Germany) and Germany

	1991-95	1996-00	2001-2005
Compensation Euro area ex D minus Germany	-0.57	1.13	1.95
Productivity Euro area ex D minus Germany	-0.57	0.00	0.00

Source: European Commission

3. If one excludes Germany from the Euro area, there still remains a pronounced growth differential vis-à-vis the United Kingdom and vis-à-vis the new member countries. As far as the United Kingdom is concerned, one can identify a much more pronounced anticyclical approach to fiscal policy. As Chart 1 shows, especially in the last subperiod, fiscal policy in the United Kingdom reacted very strongly to the shocks that affected the world economy (oil price increase, September 11, stock market crash). In the United Kingdom the structural budget was reduced from a surplus of 0.9 % in 2000 to a deficit of 3.0 % in 2005. During the same period the structural deficit of the Euro area was increased only very little from 1.4 % to 1.8 %. In other words, the aggregate fiscal policy stance of the Euro area was more or less passive. While it would be certainly inadequate to relate the whole growth differential to differences in fiscal policy, the lack of a coordinated fiscal policy seems to be a major drawback of the Euro area not only in relation to the United Kingdom but also to the United States. Chart 1 also clearly emphasized the need to reduce the deficit in "good times" or even to achieve a surplus in order to exert a sufficiently strong impact in "bad times".

Chart 1: Structural budget balance of the Euro area, the United Kingdom and the United States



Source: OECD, Economic Outlook

4. As far as the new member countries are concerned, it is certainly not surprising that their GDP growth rates have exceeded the Euro area average. In order to achieve at least a partial convergence, growth rates in these countries should exceed the Euro area average by 2 percentage points per year. Table 3 shows the number of years that the new member countries would need – given a positive growth differential of 2 percentage points – to achieve the relation of their GDP to the EU average that currently exists for Portugal, which is the poorest of the "old" member countries with a relation of its per capita GDP to the EU of 58.4 %.

Table 4: Number of years that are required to achieve a relation of the national GDP to the EU average of 58 % under the assumption of a real per capita growth rate of 2 percentage points in excess of the EU average.

Country	Current GDP per capita in EUR thousands (2003)	Number of years
Czech Republic	7.9	23
Estonia	5.9	38
Cyprus	16.1	Level already reached
Latvia	4.2	55
Lithuania	4.7	50
Hungary	7.2	28
Malta	10.6	8
Poland	4.8	48
Slovenia	12.3	Level already reached
Slovakia	5.4	42

Source: European Central Bank, own calculations

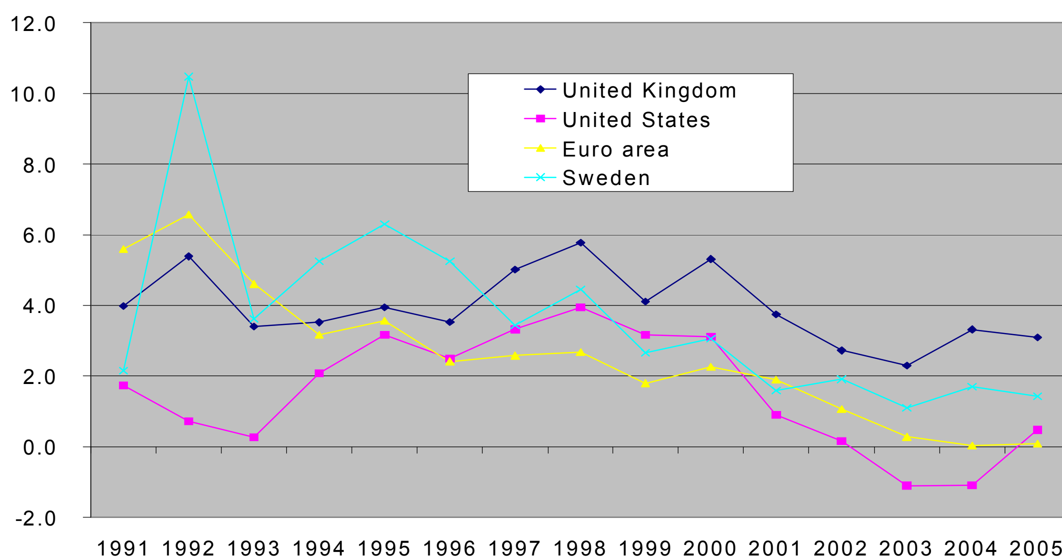
5 In sum, the growth differentials of the Euro area in relation to other EU member have to be treated very differently. There is no doubt that the new member countries need a catch-up process which seems compatible with the growth differentials that were observed so far. From the perspective of monetary policy such a catch-up process is associated with productivity differentials which give rise to the Samuelson-Balassa effect. But due to the relatively small economic size of these countries in relation to the Euro area such effects on the Euro area inflation rate are very limited.

A matter of concern is the persistent growth differential vis-à-vis the United Kingdom. It shows that the Euro area is not fully exhausting its growth potential. In this short note, I have mainly focused on differences in the management of fiscal policy, but there are not doubt also important structural differences which have to be taken into account for a complete analysis of this topic.

Similarly disconcerting is the continuing dismal growth performance of the German economy which explains a major part of the Euro areas weak growth in relation to the United Kingdom and Sweden. While a part of Germany's weak growth is related to German unification, it is surprising that the very comprehensive reforms which were undertaken in the last five years have not contributed to a reduction of the growth differential.

But all these developments do not seem to be related to the ECB's conduct of monetary policy in the last few years since real interest rates in the Euro area were on average lower than in the United Kingdom and in Sweden (Chart 2).

Chart 2: Short-term real interest rates in the Euro area, Sweden, the United Kingdom and the United States



Source: OECD, Economic Outlook

Topic 4

Conduct of monetary policy in the main areas

The Conduct of Monetary Policy in the Main Areas

Briefing Paper for the Monetary Dialogue of May 2005 by the Committee on Economic and Monetary Affairs of the European Parliament with the President of the European Central Bank

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Executive Summary

This paper compares the strategy of the euro area and the ECB for achieving price stability and a reputation for inflation aversion with those of the United States and the Federal Reserve and the United Kingdom and the Bank of England. I contrast the ECB's communication of its strategy and policy with those of the Federal Reserve and the Bank of England. Finally, I consider how open and accountable the ECB appears, compared to the Federal Reserve and the Bank of England.

I. Goals and Strategy

There is a near consensus among academics and policy makers that low and stable inflation is desirable and that monetary policy cannot be used to systematically increase output or employment. Long, variable and uncertain lags between the implementation and effects of monetary policy limit its usefulness in offsetting transitory shocks and in facilitating the, adjustment to permanent shocks. As a consequence, it is now widely accepted that the proper role for a central bank is to provide price stability. Thus, the European Central Bank (ECB) and the Bank of England, along with the Reserve Bank of New Zealand, the Bank of Japan, the Banco Central do Brazil, the Bank of Korea, the Bank of Canada, the South African Reserve, Bank and many others, have low inflation as their legislated primary goal. In contrast, the anachronistic Federal Reserve Act of 1913 asks the Federal Reserve's FOMC to pursue the impossible and poorly defined task of increasing production, promoting maximum employment and maintaining both moderate long-term interest rates and stable prices. Given policy makers' incentives to use monetary policy opportunistically, specifying price stability as the central bank's primary goal is not enough; the institutional structure of the central bank ought to be conducive to low inflation. Probably the best way to ensure low inflation is to make the central bank operationally independent, and so relatively free of the influence of politicians, and to give the central bank a simple, visible, verifiable, easily understood, rarely changing goal. This was done in the United Kingdom, and in other countries such as Brazil and Canada, by mandating an inflation target. Somewhat less appealing arrangements are the South African Reserve Bank's obligation to keep inflation within a specified band and the Bank of Korea's requirement to both set and meet an target inflation. Unfortunately, neither the ECB nor the Federal Reserve were given the benefit of such a structure; while enjoined to keep inflation low they are neither given nor required to set explicit goals. Since its inception the ECB has managed to keep inflation low; inflation has hovered just above two percent most of the time. This favourable outcome is similar to what has been achieved by the FOMC under the chairmanship of Paul Volcker and Alan Greenspan and by the Monetary Policy Committee of the Bank of England since its beginning in 1997.

As a result, policy makers at the ECB share the inflation-fighting reputation of US and UK policy makers. Unfortunately, in the euro area, as in the United States, there is a danger that simply pursuing low inflation leads to a reputation that is attached to the specific people who have been responsible for policy and not to the central banks.

The ECB has differed from the FOMC in attempting to improve upon this outcome and to attain an institutional reputation for inflation aversion by setting its own monetary policy goals. Unfortunately, the goals it has chosen have not been as simple and easy to understand as . those of the UK's MPC. And, unlike the MPC, the ECB has not been able to meet its stated aim. Worse, after failing to meet its initial self-imposed objective, it revised its target and then failed to meet the new goal.

The ECB initially defined price stability as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of less than two percent in the medium term.[1] While vague, an obvious interpretation of this definition was that the ECB was aiming for an inflation rate somewhere near the midpoint between zero and two percent. A new institution would have enhanced its reputation by sticking to and achieving its announced target. As Willem Duisenberg said, "Don't change the rules of the game when you have only just begun playing."[2]
On at least two occasions, the public was assured that no change in the target was envisioned.[3] Unfortunately, the inflation goal was not attained; average inflation was 2.3 percent in both 2001 and 2002 and, under the guise of a "clarification", on 8 May 2003 the inflation target was loosened to below, but close to, two percent.

In addition to not enhancing the ECB's reputation for inflationary toughness, the move was confusing. Rather unhelpfully, Otmar Issing further clarified that the goal was, "inflationary expectations remaining in a narrow range of between roughly 1.7 percent and 1.9 percent...." A befuddled journalist may have spoken for many when he said, "I have to communicate it, I have to write it, and I have not understood it."[4]

To summarise the above discussion, the early record of the ECB suggests that its current policy makers are committed to low inflation. However, the result of the ECB's imperfect attempt at institution building is that it may be that the ECB, as an institution, does not share the MPC's credibility.

II. Communication

If a central bank is to gain credibility for a commitment to low inflation, it must be able to convincingly communicate the reasons for its decisions. For example, consider a sharp rise in the price of oil. If the central bank perceives this rise as temporary then it may sensibly choose not to offset it; as previously argued, monetary policy has limited usefulness in offsetting transitory shocks. It is then important that the central bank quickly and clearly explain to the public the reasons for its failure to respond so that the lack of response is not perceived as resulting from insufficient determination to meet the central bank's inflation goals.

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[1] Willem F. Duisenberg, ECB Press conference: Introductory statement, 13 Oct. 1998
[2] Duisenberg, ECB press conference 12 Sept. 2002
[3] Duisenberg, ECB press conferences 19 Oct. 2000, 1 Mar 2001.
[4] Press seminar on the evaluation of the ECB's monetary policy strategy, 8 May 2003.

Compared to other central banks, the ECB has done an impressive job in justifying its actions, both in terms of the speed with which information is released and the detail. Most modern central banks, including the ECB, the Federal Reserve and the Bank of England immediately and publicly announce the results of their policy-making meetings. However, the FOMC provides only a couple of paragraphs of explanation and the MPC provides no justification whatsoever. In contrast, the ECB immediately provides several pages of detailed analysis and holds a press conference.

It is only much later that other central banks publish a more detailed discussion of their actions. The MPC publishes the minutes of its monthly meetings on the Wednesday of the second week after the meetings take place, leaving a more detailed analysis for its quarterly ‚*Inflation Report*; since January 2005 the FOMC has released its minutes three weeks after the date of the policy decision. Unfortunately, the comparative rapidity of the ECB's release of information may be a little too impressive, raising questions about how much of the report was written before, rather than after, the policy meeting.

The ECB also provides a later and more detailed analysis, publishing its comprehensive monthly bulletin one week after the press conference. In addition to written information, Executive Board members give regular speeches. This is similar to the situation in the United States, where Federal Reserve Board members give regular presentations, but contrasts with the United Kingdom; Jean-Claude Trichet has given more speeches this year than all of the members of the MPC combined.

III. Openness and Accountability

The ECB is widely viewed as more opaque in its decision making than either the Bank of England or the Federal Reserve. This is a result of its refusal to say how the Governing Council has reached a decision. No minutes or transcripts are published. Individual votes and the size of the majority are not revealed. Probing journalists are rebuked at the post-decision-making press conference with, "I do not answer questions on voting" and "As regards voting, you know I never say anything".[1]

Indeed, it is not clear that votes are ever even taken by the Governing Council or how a decision is reached if they are not. At press conference after press conference the President has emphasised that there is little dissent saying, "it became clear that taking a vote was not necessary", "there was – again – as usual, consensus", and "today's decision was, as so often, a consensus decision"[2].

The ECB regards what it refers to as the *real time* analysis of monetary policy as the cornerstone of what it thinks of as transparency.[3] Unfortunately, it appears to be more symptomatic of the ECB's secrecy. Is it really possible to summarise the analysis so quickly after the meeting? The remarkably rapid transmission of the analysis along with the insistence that there is little divergence in opinion within the Governing Council and that votes are unnecessary ‚suggests that the decisions are made prior to the meeting and merely rubber stamped by the Governing Council. But in this case, exactly *who* is making the decision?

[1] Duisenberg, 30 Aug. 2001, 7 Nov. 2002.
[2] Duisenberg, 11 Apr 2001, 5 Dec. 2002, 12 Dec. 2002
[3] See, for example, Jean-Claude Trichet, "Communication, transparency and the ECB's monetary policy," speech for the International Club of Frankfurt Economic Journalists, 24 Jan 2005.

This secretive and paternalistic attitude of senior ECB policy makers is in contrast to what prevails at many other central banks. In FOMC meetings, the Chairman makes a proposal and it is always passed with an overwhelming majority. However, the transcripts – available with a five-year lag – indicate that there is discussion and frequent disagreement before the proposal is made. The proposal that the Chairman puts forward therefore, may indicate his view of a majority opinion rather than his personal view. While FOMC members clearly dislike voting against the chairman and sometimes vote for his proposal after indicating that it is not their preferred outcome, decisions are often not unanimous.

Similarly to what occurs in the FOMC, a proposal is put to the MPC by the Governor of the Bank of England only after discussion. As with the FOMC, the MPC appears reluctant for the Governor to ever be in a minority, but there is frequent disagreement and this dissent is detailed (without names) in the minutes. Both the FOMC and the MPC publish the outcome of the votes and they name the dissenters.[1]

The secrecy of the ECB appears unappealing in a democratic society. Citizens are entitled to know who is making decisions and those who are should be accountable. In addition, the refusal of the ECB to take a vote and publish the outcome seems designed to minimise the incentives of its Council members to exert costly effort in the acquisition and procession of information.

[1] Going even further, the Bank of the Japan publishes statements by the dissenters.