Europe and the euro

The death of the stability pact
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It could be good news in the short term, but bad in the long run

DEAD, sleeping, or in the refrigerator? All these descriptions were applied to the European Union's "stability and growth pact" this week, after a majority of EU finance ministers refused on November 25th to press ahead with the sanctions envisaged under the pact for France and Germany as punishment for running “excessive” budget deficits. The European Commission had recommended that the rules be applied to the two miscreants, both of which will break the deficit ceiling of 3% of GDP for a third year running in 2004 (see chart), and both of which had refused to make the further cuts that the commission demanded.

Had the commission's recommendation been approved, France and Germany would have been forced to make those cuts. If they had refused or failed to do so, the next step would have been to levy deposits, later converted into fines, that could have run to billions of euros. Unable to accept such strictures, and jibbing anyway at the whole notion of Brussels running their national budgets, the French and Germans persuaded enough other countries to support them in rejecting the commission's proposals. The excessive-deficit procedure against the two has been “suspended”.

Gerrit Zalm, the Dutch finance minister, who, along with his Austrian, Finnish and Spanish counterparts, voted for the commission proposals, protested that some small countries had been intimidated by France and Germany. He predicted that all 12 members of the euro would now pay the price of French and German fiscal incontinence. The commission is muttering about the possibility of mounting a legal challenge to the ministers' decision. But
whatever happens, it seems clear that the sanctions mechanism—which was supposed to be the underpinning of the stability pact—has now become unenforceable.

Does this matter? In the long run, the question that Mr Zalm raises is certainly troubling. How can the euro-area stop fiscal irresponsibility in one country damaging others? And beyond the economics, there is a political problem. The EU is a “community of laws”. It is soon to adopt a constitution full of solemn and legally binding commitments, including the same excessive-deficit procedure that has just been wilfully flouted. If law is replaced by political bargaining, with bigger countries bullying their way out of a tight corner, the very basis of the Union is undermined. And it makes it far harder to insist on the new EU members who will join next May observing all the rules.

In the short term, however, the economic consequences of the trashing of the pact are more mixed. Defenders of the EU's fiscal rules—including both the commission and the European Central Bank (ECB)—always argued that the credibility of the euro depended on the enforcement of the pact. In the event, the euro rose slightly in foreign-exchange markets on the day the pact was buried. For the moment, the markets seem more worried about a weak dollar and a gigantic current-account deficit in the United States than by any fiscal problems in the euro area.

Moreover, many economists have long argued that it would make no sense to force countries such as Germany and France, already struggling to come out of recession, to cut public spending at this point in the economic cycle. Martin Baily, a former chairman of Bill Clinton's Council of Economic Advisers, calls it “Hoover-era economics”. The consequences of such a policy are already on display in Portugal, which breached the 3% limit in 2001. Under heavy pressure from the EU, the Portuguese slashed public spending and came up with a series of accounting tricks to bring their deficit back under the 3% limit in 2002. But the economy has since fallen into deep recession, tax revenues have fallen—and the budget deficit has, once again, soared out of control. Portugal has just quietly announced that its deficit for 2003 will be 5% of GDP. Francis Mer, the French finance minister, declared this week that too strict an application of the stability pact had forced Portugal into an “irredeemable recession”.

Even so, most economists consider that the euro area still needs a way of persuading countries to control their budget deficits and debts. The problem can only get more acute, because most EU countries face mounting fiscal burdens as their populations age and both pension and health-care obligations increase. The fear is that, without some common rules, countries that make painful reforms may be faced with higher interest rates caused by others' irresponsibility.

The EU has tried to guard against the danger of such pain spreading by inserting a “no bail-out clause” into the treaties that set up the single currency. This means that any country that finds itself unable to pay its debts cannot, in theory, be saved by a loan from the ECB. Again in theory, this should encourage the markets to demand different rates of interest, reflecting the different risks attached to debt issued by different euro-area countries.

Yet, in practice, the markets seem to make little distinction between the debt issued by different euro members, which suggests that investors do not really believe that there would be no bail-outs. One economist points out that the ECB's obligation to intervene to ensure the smooth functioning of credit markets in all euro-area countries could be interpreted as opening the door to possible bail-outs. More generally, it seems unlikely that the euro area would passively let a member country, especially a big one, slide into an Argentina-like default. For better or worse, the economic fates of all single-currency members are now deeply entwined.

An optimistic interpretation would be that the stability pact will now evolve from a rigid rules-based system that is both unrealistic and undesirable into a more flexible instrument that relies more on moral pressure and political understandings. But the difficulty with this idea is that the pact would then be a “gentlemen's agreement” in which some gentlemen seem more equal than others. Few observers doubt that, if Germany had been within the rules and a
smaller country had violated them, it would have been the Germans leading the chorus screaming for the rules to be enforced. And the perception that this week’s events have once again fostered of there being one rule for big countries and another for the small can only complicate already fraught negotiations on the draft EU constitution.