The euro-zone’s stability pact

Rules are made to be bent, aren’t they?

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The European Union’s “excessive deficit procedure” hangs like a sword of Damocles over the finance ministries of the euro-zone. This week the European Commission was expected to invoke it for the first time. The likely victim: Portugal.

Under their “stability and growth pact”, the 12 EU countries that use the euro promise never to run a budget deficit above 3% of GDP. If they do, in theory they can be fined up to 0.5% of GDP. Portugal will soon admit that its 2001 deficit was around 4%. With so clear a breach, the commission will have little option but to start proceedings. But it could be years, if ever, before Portugal has to pay up. It can expect a couple of years to put things right before any fine is enforced, and each step in the procedure has to be endorsed by the EU’s Council of Ministers. The national ministers assembled there will bend over backwards to be nice: who wants to impose a swingeing fine on a friend? Besides, some are all-but rule-busters themselves.

But Portugal has one particular vulnerability. It is one of four poor EU members that get “cohesion funds” from Brussels to help them catch up with richer ones. That money, more than euro6 billion ($6 billion) over six years, might have to be suspended at once if the council allows the deficit procedure to go ahead. The legalities are obscure; the commission is looking into them. But the consequences could be grave for a small country already having to tighten its belt, and long reliant on big infrastructure projects to boost growth.

Portugal illustrates the flip-side of euro-zone membership. It has seen the benefits: lower interest rates, no more roaring inflation and weak escudo. The government and consumers have gone on a binge: the current-account deficit is near 9% of GDP. Use of the euro protects Portugal from a run on the currency. But the rules are there to stop one reckless government endangering the currency and credit rating of all. Even if Portugal is never actually fined, it cannot run huge deficits for ever. Its new centre-right government is already under heavy pressure from its euro-zone partners, and cutting back. The economy may shrink this year.

Yet a small country cannot really affect the euro. In contrast, Italy, France and Germany—jointly, 70% of the euro-area’s GDP—could. It is their adherence to the pact that really exercises officials in Brussels. None of the big three is forecast to breach the 3% deficit-limit this year. But all are bending another part of the pact, which requires all EU members to aim for budget balance in normal economic times. All have promised to reach balance by 2004.
But it is increasingly apparent that the big three want to wriggle off the hook.

At a recent EU summit, France asked for an extension of the deadline to 2007—and when that was refused, it announced that it would not feel bound to respect its pledges, if its economic growth fell below 3%. The Italians have also announced that, in their view, the pact has been loosened and that they will proceed with tax cuts and extra spending on education. Germany, whose deficit may hit 2.8%, is nearest the limit. It has promised solemnly to rein in spending, in exchange for avoiding a formal warning from Brussels earlier this year. But that promise too may be bent: Germany has a general election in September. And the whole EU risks a worsening of the economic climate. So the commission may later this year find itself in the embarrassing position of trying to issue warnings to the three biggest countries.

A public-relations problem to be sure, but is it anything worse? Optimists point to the euro’s recent swift rise against the dollar. Financial markets are far more worried by America’s corporate scandals than the twists and turns of the stability pact. Maybe, respond the commission and the European Central Bank, but the point of the pact is not to influence the daily gyrations of markets. The real concern is that most euro-area countries have ageing populations and large, unfunded pensions liabilities. If they cannot control their budgets now, they will face ever worse problems as the years roll by.

So why not revise the pact, to aim it more precisely at these concerns? For example, some French officials argue that Brussels should be less strict with countries that have relatively low levels of public debt. A budget deficit, they argue, is one thing in heavily indebted Italy (whose deficit forecast for this year some in the commission much doubt, after a statistical wrangle that hiked the Italians’ claim of 1.6% for last year to the commission’s 2.2%). A deficit is less serious in France or Germany, whose public balance-sheet is in a better state. And not all types of public spending are the same. Britain is not in the euro-zone, but is committed to budget balance in normal times. Unfair, say some in London: we have little public debt and badly need to spend on public services. Surely the EU should distinguish necessary investment from loose current spending that brings persistent structural deficit?

So far the commission seems unconvinced. It says it already takes debt and pensions and the like into account when issuing its fiscal advice. But it will not consider letting some countries ignore the 3% limit or defer balancing their budgets. The Eurocrats know that EU governments have already proved worryingly adept at finding loopholes in the stability pact, and are disinclined to introduce new ones.