Europe's fiscal follies

Unstable and incredible
Nov 27th 2003
From The Economist print edition

Now that the “stability and growth pact” is defunct, what should replace it?

The death throes have been painfully drawn-out. But this week, at long last, Europe's finance ministers have killed the ill-named “stability and growth pact”. The pact, memorably dubbed “stupid” by the European Commission’s president, Romano Prodi, supposedly limited budget deficits for euro members to no more than 3% of GDP, on pain of fines as big as 0.5% of GDP. By 2005 both France and Germany will have exceeded the 3% ceiling for four years running. And yet, to the disgust of the commission and a handful of indignant small countries, the French and the Germans have persuaded their fellows to let them off the hook. Nobody failed to see the irony that it was Germany which, in the late 1990s, had insisted on a rigid stability pact as its price for accepting the euro.

The battle is not quite over, as the commission and some smaller countries are threatening legal action (see article). But the assumption must be that all sanctions under the stability pact are now a dead letter. Despite this, the “excessive-deficit procedure” that lays down the rules is likely to be included unchanged in the EU constitution due to be agreed next month. Even by the insane standards of Brussels, that makes no sense. Instead, having tried the rules and—as many, including this newspaper, long predicted—found them wanting, governments should now devise a new regime for fiscal policies.

One possibility would be simply to amend the ceiling on budget deficits, for instance raising it to 4%, or varying it according to countries' positions in their economic cycles. Most economists agree that it would have been foolish in the extreme for France and Germany, both just emerging from near-recession and both suffering from a strong euro, to tighten their fiscal policies any further at this point. But the trouble is that even a higher ceiling would remain just as arbitrary as today's 3%. Changing the figure to take account of the cycle would make more sense, but it would introduce a complex and disputable new calculation, with countries arguing endlessly over precisely where they were in the cycle.
A better idea would be to scrap the stability pact altogether. After all, a monetary union takes away its members’ discretionary control over monetary and exchange-rate policies. Arguably, therefore, they need more, not less, fiscal freedom. And, as the European treaties make clear, national governments are responsible for their own debts: any bail-outs by the European Central Bank (ECB) are explicitly banned. So if a country were to borrow too much, or even to be threatened with bankruptcy, that should be a problem for it and its creditors alone. Financial markets could then be trusted to administer the necessary discipline on excessive deficits, by pushing up interest rates on an errant government’s debt.

It all sounds eminently sensible. Yet it may not be wholly realistic. If any member of the euro went bust, it is hard to imagine that others would stand by unmoved—just as it is hard to imagine the American federal government ever letting a big state go under. That is one reason why 49 of the state constitutions ban budget deficits (although, as California shows, such bans can be circumvented). Moreover, any country that became overly indebted might start to agitate for higher inflation to erode the burden. And there is a potential free-rider problem: if Germany, say, ran large budget deficits, the markets might spread the pain of higher interest rates to all countries in the euro—rather as happened in Europe’s then exchange-rate mechanism after German unification in 1990.

**A European IMF**

In practice, markets seem to assume that no euro member would ever be permitted to go bust. That means that all members have a legitimate interest in each other’s fiscal policies. Yet, as the short-lived experience of the stability pact has shown, any notion of sanctions against excessive borrowers is wholly misconceived, because such measures will never be allowed to bite. The answer is to junk sanctions and rely instead on some kind of mutual surveillance that draws the attention of markets (and voters) whenever a country gets on to a dangerously unsustainable path. The focus of such surveillance should not be annual budget deficits but levels of public debt and, even more crucially, of such implicit off-the-books obligations as future pensions and health-care costs.

The force of any such surveillance will depend a lot on who is the watchdog. The commission is one candidate, but it has been discredited by the death of the stability pact, is prone to political influence, and no longer carries credibility. A better choice, despite its quixotic support for the present pact, might be the ECB, which could play a role rather like that of the International Monetary Fund. It would be important to restate, yet again, that the ECB can never bail out a national government. But getting it to utter loud fiscal warnings would surely concentrate markets’ minds. It might even deter profligate governments: certainly more so than a toothless stability pact.

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