



Chapter 17: Fiscal policy and the Stability Pact

*I know very well that the Stability Pact is stupid,
like all decisions which are rigid.*

Romano Prodi (EU Commission President), Le Monde, 17 October 2002

The Economics
of European
Integration

Richard Baldwin
Charles Wyplosz

fourth edition



Fiscal policy in the monetary union

In a monetary union, fiscal policy:

- the only macroeconomic instrument at national level;
- government borrows in slowdown and pays back on behalf of citizens;
- government acts as substitute to inter-country transfers in case of asymmetric shock.

Problems of fiscal policy:

- effectiveness of fiscal policy depends on private expectations;
- slow implementation.

Fiscal policy in the monetary union

Crucial distinction:

- automatic stabilizers: fiscal policy is spontaneously countercyclical:
 - tax receipts decline when the economy slows down;
 - welfare spending rises when the economy slows down;
 - no decision, so no lag: nicely countercyclical
 - rule of thumb: deficit worsens by 0.5% of GDP when GDP growth declines by 1%.

Table 17.1 Sensitivity of government budget balances to a 1 per cent decline in economic growth

Country	%	Country	%	Country	%	Country	%
Germany	0.5	Austria	-0.5	Greece	-0.6	Portugal	-0.4
France	-0.5	Belgium	-0.5	Ireland	-0.4	Spain	-0.5
Italy	-0.4	Denmark	-0.7	Netherlands	-0.6	Sweden	-0.5
UK	-0.6	Finland	-0.5				

Fiscal policy in the monetary union

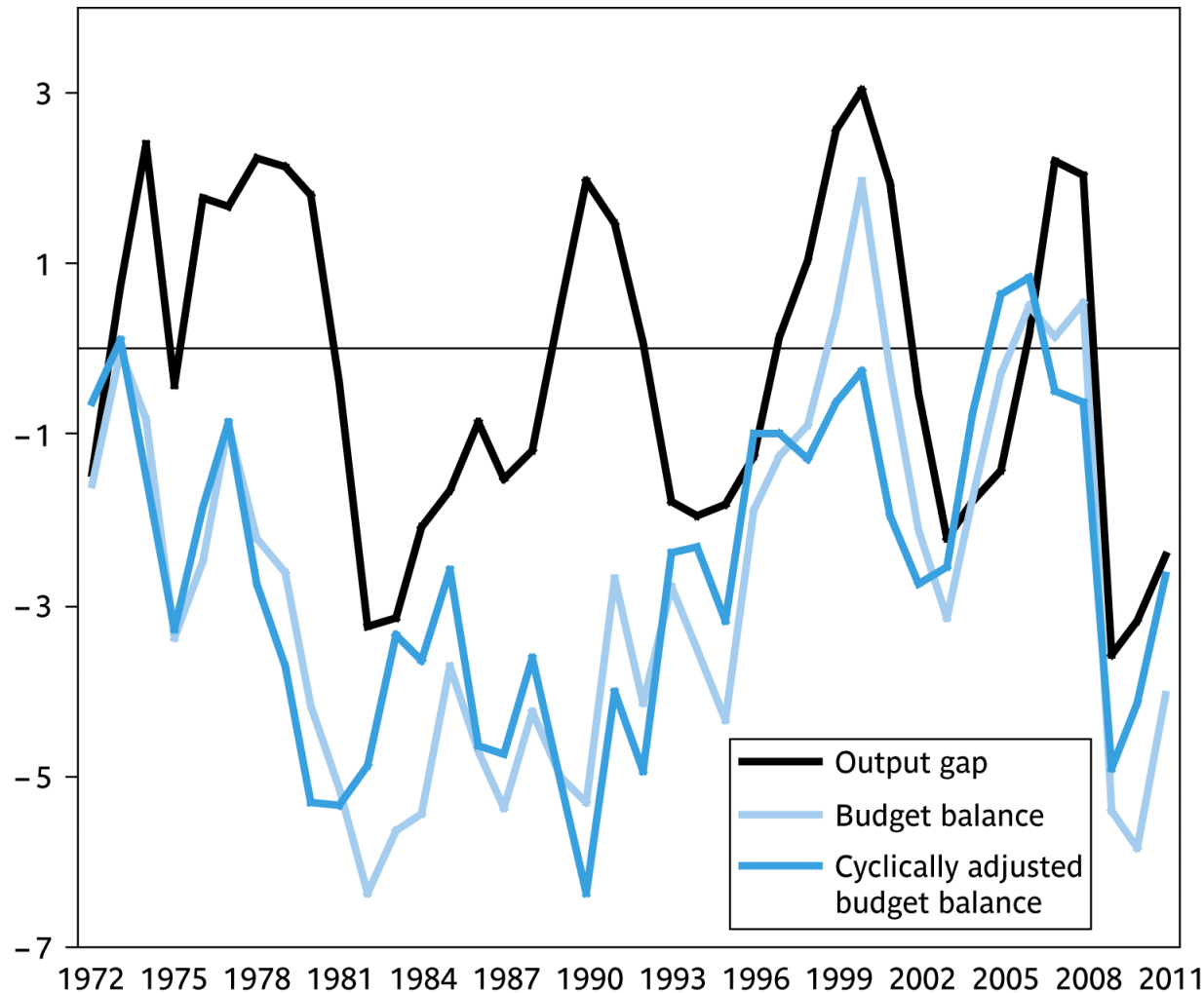
- discretionary fiscal policy: a voluntary decision to change tax rates or spending.

Because of automatic stabilizers, budget figures do not reveal what governments do with fiscal policy. Cyclically adjusted budget shows what the balance would be if the output gap is zero in a given year.

Difference between actual and cyclically adjusted budget = footprint of automatic stabilisers.

Fiscal policy in the monetary union

Actual and cyclically adjusted budgets in the Netherlands, 1972–2011:

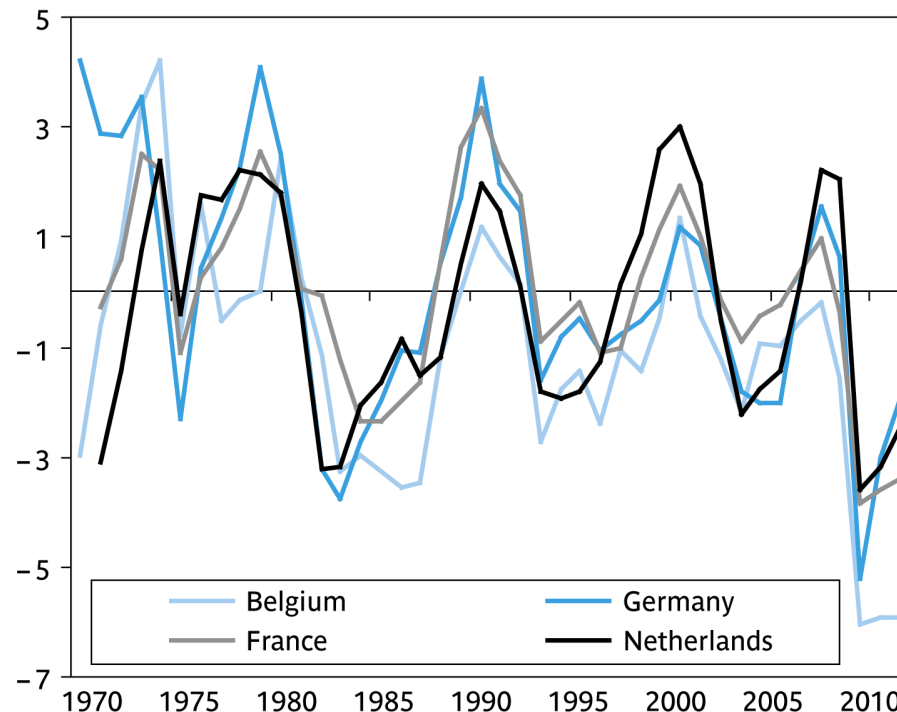


Fiscal policy externalities

Should fiscal policy be subjected to some form of coordination? Yes, if national fiscal policies are a source of externalities:

- cyclical income spillovers via trade, strengthened by monetary union through increased trade.

Income spillovers, 1970–2011:



Fiscal policy externalities

- borrowing cost spillovers, as one country's deficit would induce higher interest rate for everyone:
 - weak argument since euro area integrated in world financial markets;
 - still, capital inflows can appreciate common currency and affect competitiveness.
- excessive deficits, which may lead to default:
 - capital outflows and a weak euro;
 - pressure on other governments and Eurosystem to help out.

→ 'no-bailout' clause in Maastricht Treaty.

Fiscal policy externalities

- deficit bias and collective discipline: build-up of debt reflects failure of democratic control over governments.

Table 17.2 Public debts in Europe (% of GDP), 2011

Austria 73.8	Belgium 97.0	Bulgaria 18.0	Cyprus 62.3	Czech Rep. 41.3	Denmark 45.3
Estonia 6.1	Finland 50.6	France 84.7	Germany 82.4	Greece 157.7	Hungary 75.2
Ireland 112.0	Italy 120.3	Latvia 48.2	Lithuania 40.7	Luxembourg 17.2	Malta 68.0
Netherlands 63.9	Poland 55.4	Portugal 101.7	Romania 33.7	Slovakia 44.8	Slovenia 42.8
Spain 68.1	Sweden 36.5	UK 84.2		EU27 82.3	Eurozone 87.7

Principles

At which level of government (regional, national, supranational) should policies be conducted? The theory of fiscal federalism deals with this question.

Two arguments for sharing responsibilities:

- externalities;
- increasing returns to scale.

Two arguments for retaining sovereignty:

- heterogeneity of preferences;
- information asymmetries.

Theory of fiscal federalism does not provide a general answer: case-by-case approach and often we face trade-offs with no compelling answer.

Principles

Four arguments for and against centralization at the EU level are unlikely to lead to clear-cut conclusions.

Where should the burden of proof lie? The EU has taken the view that the burden of proof lies with those who argue in favour of sharing sovereign tasks: principle of subsidiarity.

In other words: unless there is a strong case of increasing returns to scale or of externality, the presumption is that decisions remain at the national level.

Principles

What does it all mean for fiscal policy in the Eurozone?

In true federal states, there is a powerful federal level of government. In the Eurozone, instead, the Commission budget is far too small to play any macroeconomic role.

The case for policy coordination is convincing. A step has been taken in 2011: 'European semester'. In January of each year, the Commission presents its Annual Growth Survey, including forecasts and evaluation of member countries' economic situation. This triggers discussions among governments and in the European Parliament. Following recommendations by the Council, every government submits to the Commission their Stability and Convergence Programmes. The Commission then assesses the national programmes and submits its conclusions and recommendations in time for the June Council.

The Stability and Growth Pact (SGP)

Adopted in 1997, the SGP was meant to avoid excessive deficits, with fines for countries not respecting it. Enforced by ECOFIN, countries (e.g., France and Germany in 2003) avoided fines. SGP was reformulated in 2005 to avoid its rigidity.

The SGP consists of four elements:

1. definition of what constitutes an 'excessive deficit';
2. preventive arm, designed to encourage governments to avoid excessive deficits;
3. corrective arm, which prescribes how governments should react to a breach of the deficit limit;
4. sanctions.

The SGP applies to all EU countries but only the Eurozone countries are subject to the corrective arm.

The Stability and Growth Pact (SGP)

1. 'excessive deficit'; deficits are excessive when above 3% of GDP; countries in the monetary union commit themselves to a medium-term budgetary stance 'close to balance or in surplus'; 'exceptional circumstances' when provisions are automatically suspended;
2. preventive arm: in the form of peer pressure. Finance Ministers engage in a collective discussion of one another's fiscal policy;
3. corrective arm: 'early warning' and recommendations when deficit is believed to breach the limit; excessive deficit procedure for excessive deficit: recommendations, to be followed by corrective measures, and ultimately sanctions;
4. sanctions: if a country fails to take corrective action and bring its deficit below 3%, it is sanctioned. The fine starts at 0.2% of GDP and rises by 0.1% for each 1% of excess deficit.

SGP does not remove fiscal policy sovereignty: governments are in full control. Also, its intent is clearly pre-emptive.

SGP and countercyclical fiscal policies

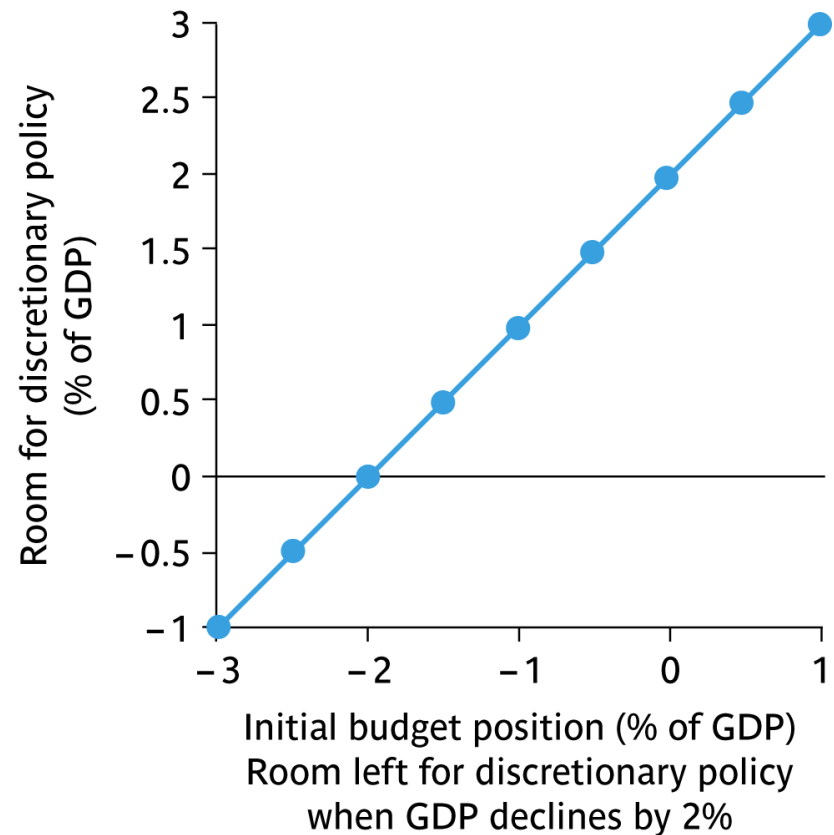
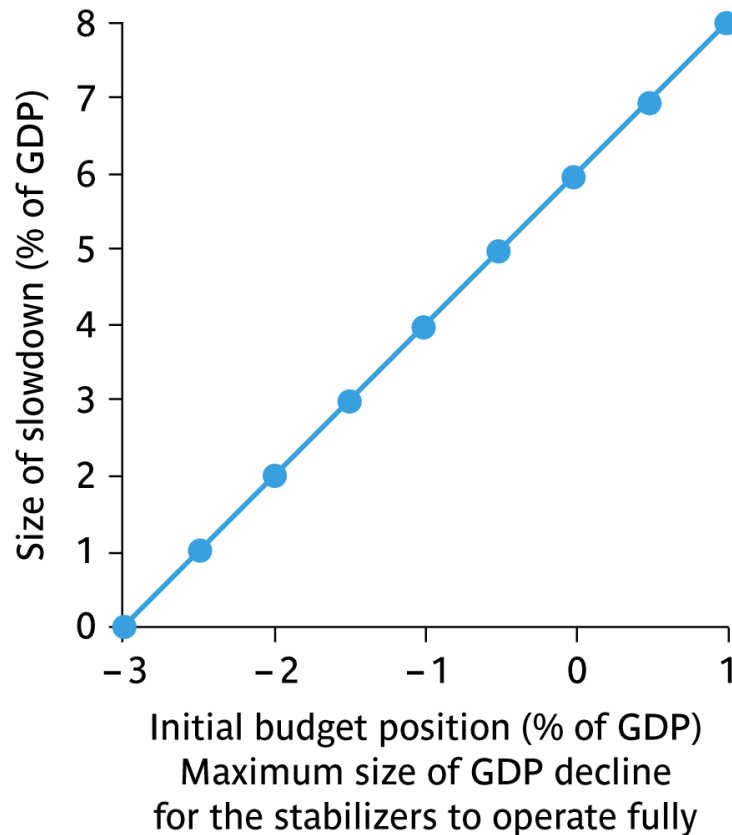
Does the Pact impose procyclical fiscal policies?:

- budgets deteriorate during economic slowdowns;
- reducing the deficit in a slowdown may further deepen the slowdown;
- a fine both worsens the deficit and has a procyclical effect.

Solution: a budget close to balance or in surplus in normal years.

SGP and countercyclical fiscal policies

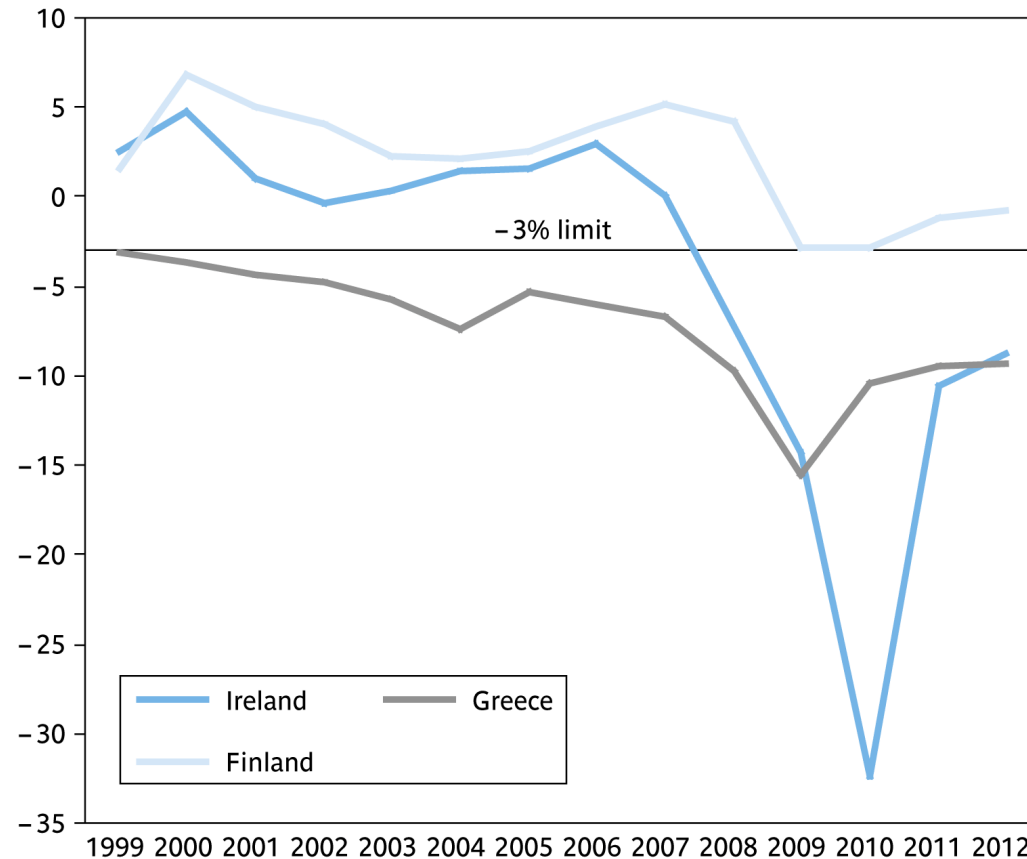
If budget in balance in normal years, plenty of room for automatic stabilisers and some limited room left for discretion action.



SGP and countercyclical fiscal policies

SGP is designed to provide a strong incentive for each government to bring its budget to a position of balance (or surplus) in good years.

Budget balances since 1999 (% of GDP):



Euro Plus Pact

Limits of SGP became obvious with debt crisis. A reform informally adopted in 2011: Euro Plus Pact (still to be adopted).

It aims at strengthen and expand the Pact (reversing the 2005 reform). and makes no reference to the no-bailout clause:

- deficit target: cyclically adjusted primary budgets must be balanced;
- debt target: evolution of the debt will be one criterion used to evaluate policies (by end 2011, the debt average is close to 90% and the old target is beyond reach for many years to come);
- sanctions: decision procedure much more certain and automatic. If the pact is put into place, the Commission recommendations will be automatically accepted unless a qualified majority (two-thirds of the vote) decides to the contrary;
- implicit liabilities: member governments should start planning for the ageing phenomenon.

Ten years of the Stability and Growth Pact

Table 17.5 Excessive deficit procedures since 1999

Austria	2009		
Belgium	2009		
Cyprus	2010		
France	2003	2009	
Germany	2003	2009	
Greece	2004	2009	
Ireland	2009		
Italy	2004	2005	2009
Malta	2009		
Netherlands	2004	2009	
Portugal	2002	2005	2009
Slovakia	2009		
Slovenia	2009		
Spain	2009		



Chapter 19: The Eurozone in crisis

We knew that a storm was brewing but, admittedly, we did not know exactly where. Neither did we know what would trigger it, or when it would come.
Jean-Claude Trichet, President of the ECB. Keynote address in 2009.

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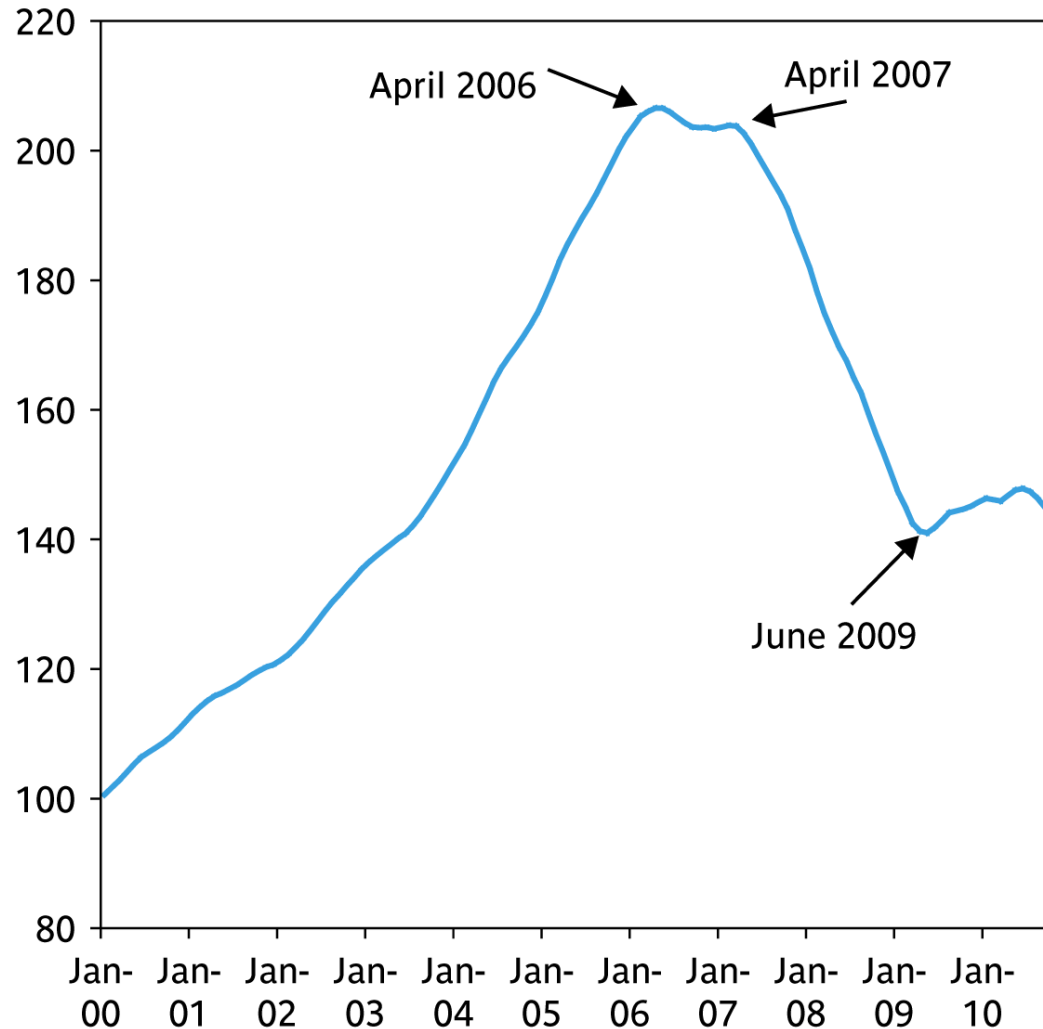
Stage one: the global financial crisis

Following Great Depression, strict regulation was designed to limit risk-taking by banks and financial institutions. The deregulation phase started in the 1980s, followed by a rapid expansion of financial sectors in the USA and Europe:

- banks became active investors:
 - maturity mismatch;
 - currency mismatch;
- banks took major risks, implicitly borne by their governments;
- house mortgages in the US to risky people: subprime mortgages, which relied on ever increasing house prices. And these loans were sold to banks, which sold them to other banks (i.e., securitization).

Stage one: the global financial crisis

Housing prices in the USA (Index: January 2000 = 100):



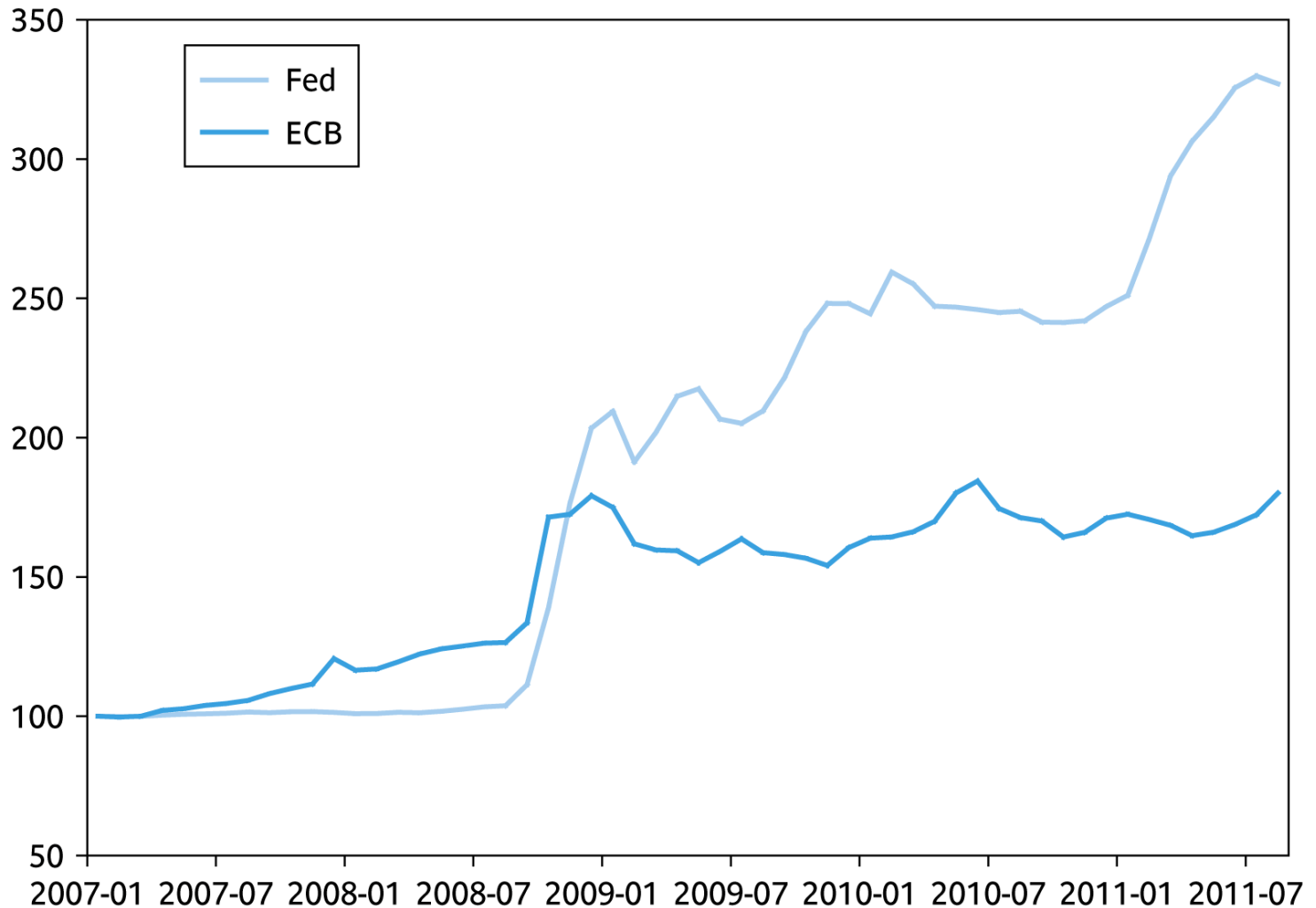
Stage one: the global financial crisis

When house prices stopped rising, securities lost their ratings and many of the world's largest banks (especially in US, UK, France, Germany) faced heavy losses.

- April 2007: New Century Financial Corporation (one of the largest US mortgage lenders) declared bankruptcy;
- July 2007: bank Bears Stearns announced that it would stop honouring the commitments of one of its SPVs;
 - banks grew suspicious of one another and stopped their mutual lending that makes up the interbank market.
 - central banks provided liquidity directly to their banks.
- September 2007 – spring of 2008: several major banks failed;
- 15 September 2008: failure of Lehman Brothers triggered the worst financial crisis since 1929.

Stage one: the global financial crisis

Assets of central banks (Index: January 2007 = 100):



Stage one: the global financial crisis

Policy makers (governments and central banks) followed the lessons learned from the Great Depression:

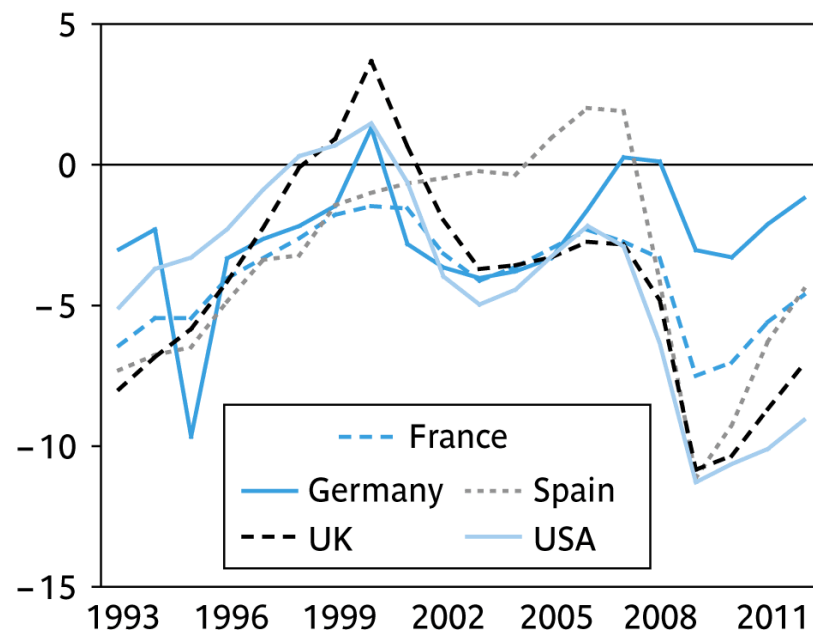
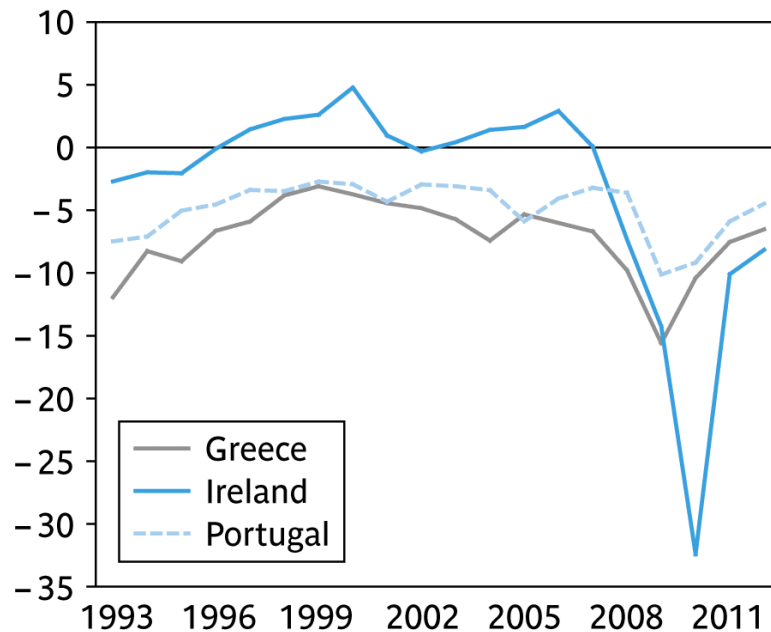
- rescue large financial institutions;
- deep distress in the financial system is soon followed by a profound and long-lasting recession;
- central banks must provide liquidity to the financial system and adopt sharply expansionary policies;
- governments must bail out banks and other financial institutions;
- governments must use fiscal policy to prevent a vicious cycle of recession and large budget deficits.

The London G20 Summit in 2009 called upon all governments to urgently adopt expansionary policies.

Stage one: the global financial crisis

These actions had dramatic impacts on budget deficits (e.g., in 2010, Irish government spent almost 30% of its GDP on bank bailouts).

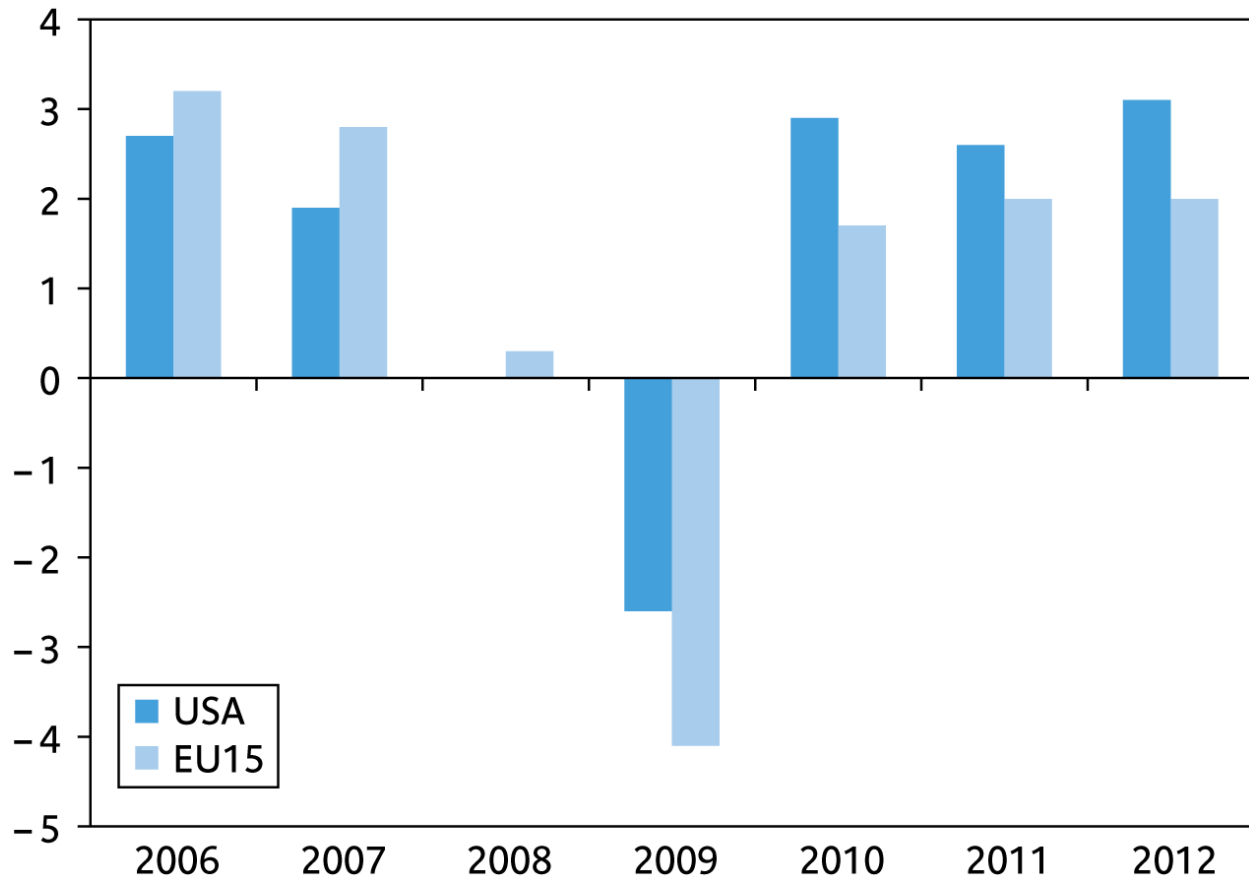
Budget balances 1993–2012 (% of GDP):



Stage two: the public debt crisis in the Eurozone

The recession has been deep but relatively short-lived!

GDP growth 2006–12:



Stage two: the public debt crisis in the Eurozone

However negative growth and large budget deficits have led to a fast increase in public debts:

- financial crisis has led governments to run budget deficits;
- deficits have led financial markets to worry about the sustainability of public finances.

Greece:

- late 2007: public debt at 105% of GDP;
- late 2009: public debt at 127% of GDP;
- early 2010: Greek government in desperate situation;
- May 2010: IMF–EU–ECB (called Troika) rescue operation and creation of European Financial Stability Facility (EFSF);
- 2011: new package from the Troika.

Stage two: the public debt crisis in the Eurozone

Bailout of Greece in May 2010 was motivated as a way to avoid highly dangerous contagious effects but this goal proved elusive:

- Ireland received a loan in November 2010;
- Portugal followed suit with a loan in May 2011.

Contagion within the Eurozone is highly troubling since public indebtedness is not enough to explain why these countries, and not others, have faced the wrath of the financial markets.

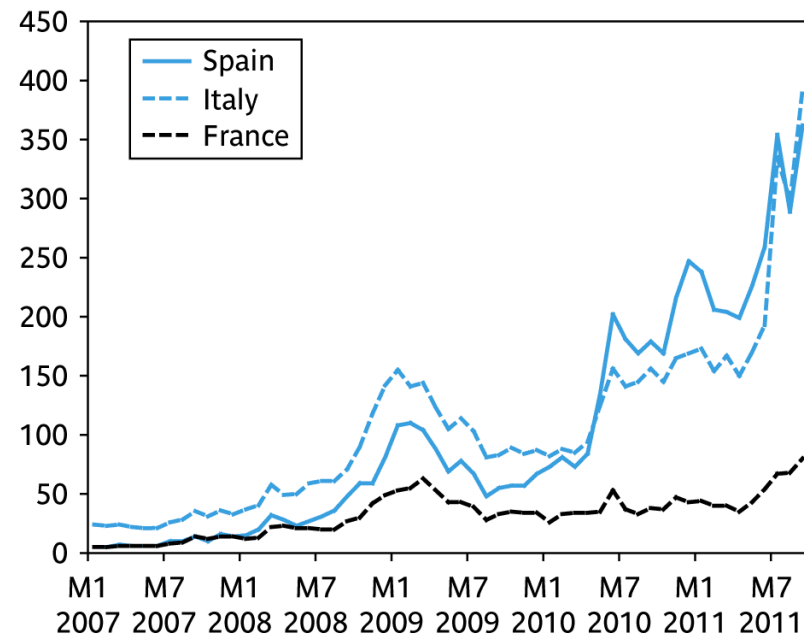
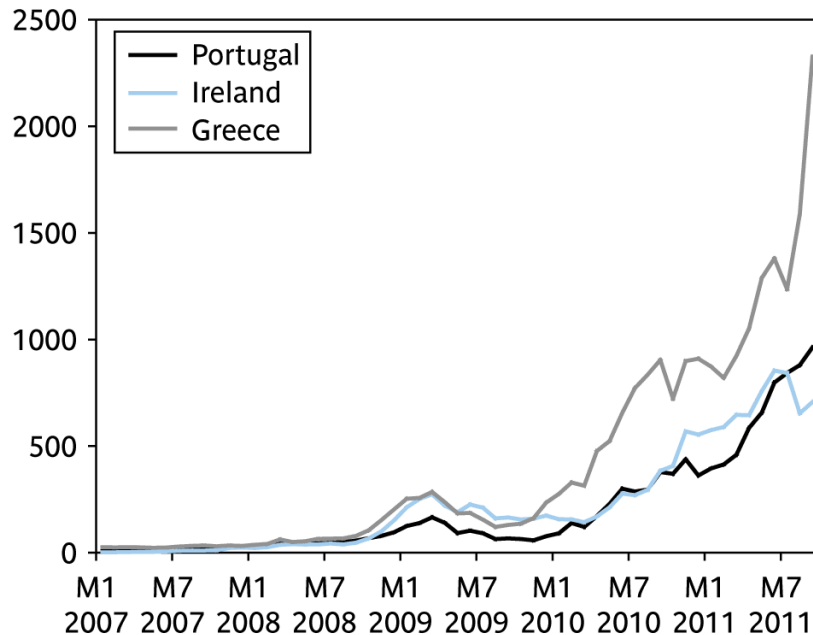
Possible explanations:

- membership of a monetary union may be a weakness (national central banks cannot help government);
- EFSF spread contagion, instead of preventing it, by signaling willingness to bail out countries subject to market pressure.

Short-term policy responses

Step increases in interest spreads (below) is due to policy decisions that markets perceived as 'too little, too late' (e.g., EFSF).

Interest rate spreads (basis points):



Short-term policy responses

Fiscal policy strategy: fiscal austerity.

EFSF: resources in case of contagion.

Banks hold sizeable amounts of government's debt: doubts about any government's debt translate into doubts about health of banks. Governments reacted by denying the link (i.e., stress tests).

How to stop the crisis? Crisis has two components:

- public debt crisis: it requires debt restructuring (as Greece did);
- banking crisis: it requires bank recapitalization.

Long-run solutions

Crisis has exposed key weaknesses of the Eurozone construction.

Fiscal discipline:

- favoring more integration: less sovereignty and Eurobonds;
- favoring institutional channel: formally requiring that Eurozone membership be subject to the adoption of adequate fiscal institutions tailored to each country's own political traditions.

Bank regulation and supervision:

- a number of institutions have been created but they do not replace comparable pre-existing state-level institutions (except ESRB);
- eventually, regulation and supervision will have to be replaced by, or put under the authority of, Eurozone authorities.

Long-run solutions

ECB as lender of last resort:

- no-bailout clause (largely ignored) rules out ECB interventions when states are unable to pay;
- rethinking of role and actions of ECB.

Governance of the Eurozone:

- de facto management of crisis by France and Germany while the Commission has been largely passive;
- Eurozone needs its own system of governance.

Will the Eurozone break up?

Yes:

- failure to establish fiscal discipline;
- gap between well-functioning North and badly wounded South;
- many international investors do not believe that the euro can survive (self-fulfilling process).

No:

- breakup would have catastrophic implications;
- new currency would have to be printed and reintroduced;
- no legal procedure for a country to leave the Eurozone;
- deeper problem has been political mismanagement of the crisis.

→ No clear-cut economic gain.