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What Europe Should Do: Getting the Macroeconomics Right

We live in an era when rapid change breeds fear, and fear too often congeals us into a rigidity, which we mistake for stability.

—Lynn White, Jr.

Getting the macroeconomics right means getting fiscal and monetary policy right in terms of their effect on aggregate demand. As we have noted more than once in this book, structural reforms will not restore economic growth in Europe unless there is sufficient aggregate demand in the economy. The big issue in Europe's fiscal policy is the Stability and Growth Pact (SGP).[1] The big issue in monetary policy is the behavior of the European Central Bank (ECB). This chapter explores both of these issues.

The Stability and Growth Pact

The SGP is currently at the forefront of Europe's political and academic economics agenda because it required some governments to cut their deficits in 2003 (and will again in 2004)—even during a period of economic weakness. There is general agreement that constraints should be placed on member countries' fiscal policies so that excessive deficits in one or more countries do not undermine the euro or overall EU stability. But at the same time there is a real concern that the SGP could force contractionary fiscal policies on economies that are already weak. These concerns raise the

1. The SGP is a complex set of interrelated rules agreed upon in the years since the original proposals for a European monetary union were laid down in the Treaty of Maastricht in 1992. As such, coercive measures were agreed upon only in 1997, though they refer to standards laid down as early as 1992. In this book, the term SGP will be used as a broad definition—as the sum of all different EU legal instruments on fiscal policy.

question about whether or not the SGP is fundamentally flawed or simply improperly implemented. This section will first explain the different legal components and constituents of the SGP and the potential flaws of this legal design. It then goes on to illustrate how—at the time of its inception—political considerations played a decisive role in determining the SGP's implementation procedures. There is also a review of member countries' compliance to the SGP since 1999. As this is written in mid-2004 some have pronounced the SGP dead because France and Germany have said they will not comply with its provisions.

The main criticisms leveled by numerous academics and officials against the SGP are then discussed together with alternative reform proposals. The section concludes by setting out some minimum requirements for any sensible SGP-like instrument as well as a number of specific rules that should be included in it.

The Nature of the Stability Pact

The SGP was instituted under the third stage of the European Monetary Union (EMU) and consists of several legal instruments.[2] Budgetary rules are included in the EU Treaty (Treaty),[3] and these provisions of the Treaty are enforceable through the European Court of Justice (ECJ). (The Treaty in Europe is somewhat comparable to the role of the Constitution in the United States—at least until a new European Constitutional Treaty is agreed upon.)

There are also budgetary rules adopted by the European Council (Council).[4] These have the force of law within the European Union as well, but can be changed by subsequent Council votes. A resolution of the European Council established the SGP, together with provisions to prevent violations (EU Council Regulations 1966/97) and to outline coercive steps if a violation occurs (EU Council Regulations 1467/97). The European Commission also plays an important role by monitoring compliance with the SGP and making recommendations to the Council for sanctions in the event of a violation.

2. Legal and political distinctions must be carefully made, especially as key reference values are repeated throughout the chapter. This section is based on the European Commission description of activities under the EU framework for budgetary surveillance, www.europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm (accessed October 28, 2003).

3. This discussion refers to the treaties of Maastricht, Amsterdam, and Nice as simply the EU Treaty. However, all article reference numbers will be to the consolidated version of the Treaty Establishing the European Community, europa.eu.int/eur-lex/en/treaties/selected/livre2_c.html (accessed October 28, 2003).

4. The European Council refers to the gathering of member states' heads of government (and/or state) and is the highest executive authority in the European Union.

The budgetary rules in the EU Treaty require member states[5] to avoid excessive government deficits (Art. 104.1). The rules also charge the European Commission (Art. 104.2) to monitor the development of the budgetary situation and the stock of government debt in individual member countries using two criteria:

- a reference value for the ratio of the planned or actual government deficit[6] to GDP at market prices (the government deficit flow variable);
- a reference value for the ratio of government debt[7] to GDP at market prices (the government deficit stock variable)

The EU Treaty refers only to given reference values and calls for the numerical targets to be spelled out in a Protocol to the Treaty, which would later be replaced by appropriate provisions adopted by the European or ECOFIN Council. Currently the reference values are 3 percent for budget deficits and 60 percent for government debt (see below).

Exceptions to the 3 percent rule can be made if the ratio has declined substantially and continuously and reached a level that comes close to 3 percent, or if the ratio remains close to the reference value and any excess over 3 percent is exceptional and temporary. Also, the 60 percent government-debt ceiling can be sidestepped if the ratio is sufficiently diminishing and approaching 60 percent at a satisfactory pace. If a member state does not fulfill either of the two obligations,[8] the European Commission is charged with preparing a report (Art. 104.3) to the ECOFIN Council[9] and the Economic and Financial Committee.[10] In the report, the

5. It is important to notice that the obligations of the EU Treaty encompass all EU members and not only those members who have actually adopted the third stage of the EMU (i.e., the euro).

6. Government is defined as general government—including central, regional, and local government and social security funds, excluding commercial operations. Deficit refers to net borrowing as defined in the European System of National and Regional Accounts (ESA95).

7. Total gross debt at nominal value outstanding at the end of the year and consolidated between and within the sectors of the general government.

8. Even if a member state complies with the requirements, the European Commission can still prepare a report if it believes that the risk of an excessive deficit exists.

9. The ECOFIN Council consists of the finance ministers of member states, who hold the following number of votes respectively: Germany, France, Britain, and Italy each have 10 votes; Spain has 8 votes; Belgium, Greece, the Netherlands, and Portugal each have 5 votes; Austria and Sweden each have 4 votes; Denmark, Ireland, and Finland each have 3 notes; and Luxembourg has 2 votes. A qualified majority is defined as two-thirds (58 votes) of the total 87 votes, which means that 29 votes form a blocking minority.

10. This committee acts strictly in an advisory role to the ECOFIN Council on the subject of the European Commission's report and consists of two members from each member state, two members from the ECB, and two members from the European Commission.

Commission describes the fiscal situation in the member state, explicitly taking into account: whether the government deficit exceeds government-investment expenditure; the medium-term economic and budgetary position of the member state; and other factors deemed relevant.

The ECOFIN Council then decides, by qualified majority, whether an excessive deficit exists (Art. 104.6). If an excessive deficit is deemed to exist, the ECOFIN Council makes recommendations to the offending member state on ways to bring an end to it *within a given period*.[11] If the member state does not rectify its excessive deficit in a timely manner, the ECOFIN Council may then apply one or more of the following measures (Art. 104.11):

- require the member state to publish specified information before issuing bonds or securities;
- invite the European Investment Bank (EIB) to reconsider its lending policy toward the member state concerned;
- require the member state to make a noninterest-bearing deposit of an appropriate size with the EU Commission until the excessive deficit has been corrected; and/or
- impose fines of an appropriate size.

Finally, Article 104.14 spells out that only by a unanimous vote on a proposal from the European Commission—and after consultations with the ECB and the European Parliament—can the ECOFIN Council replace any reference values (currently 3 percent of the deficit or the 60 percent of the debt values) in this Treaty. Moreover, Article 104.14 also requires the European Council to establish the detailed rules and definitions for implementing the Treaty provisions (by qualified majority and after consultations with the European Parliament). Article 104.14 also outlines how European and ECOFIN Council resolutions for numerical targets and procedural guidelines can be used to make changes, which was crucial to the adoption of the SGP by the European Council in June 1997, since it provided political room for maneuvering in case of a future crisis.

Thus, the 3 percent and the 60 percent reference values are laid down in a Protocol to the Treaty, rather than in the Treaty itself. This clearly eases the obstacles to changing these reference values, since ratification by national parliaments and/or electorates is not required. On the other hand, the Treaty itself requires that reference values exist and that they be adhered to, and demands unanimity for them to change. Since it is virtually impossible to change the Treaty—or achieve unanimity among EU

11. The member state in question is excluded from votes on this and subsequent procedures.

member states for reference value changes—these values can be considered permanent for the foreseeable future.

It is, thus, noteworthy that despite the controversy surrounding the SGP, it is included almost verbatim in the Provisional Treaty Establishing a Constitution for Europe, which was published by the conference of member state representatives. Constitutional Treaty article III-76 and the attached Protocol, which contain reference values for the excessive deficit procedure, replicates the existing Treaty with only one major change: A qualified majority in the European or ECOFIN Council is now defined as the votes of 55 percent of member states representing at least 65 percent of Council member states' populations (see footnote 9 for existing rules).[12] Hence, an obvious chance to change the legal text of the SGP as part of the EU Constitutional Treaty process seems to have been deliberately missed. Alas, considering the difficulties in changing a new Constitutional Treaty, this may have been the last chance to make such a change for some time.

As stated above, the Treaty does provide the political opportunity to sidestep both the 3 percent and 60 percent reference values in special circumstances. However, any attempt to circumvent the letter of the EU Treaty—for example, by European Council decisions under Article 104.14—could be challenged in the ECJ, which is the final arbiter in cases involving the Treaty. Any legal proceeding in the European Court would, even with expedited procedures, take time to resolve and, as the European Commission would almost certainly be pitted against member states, greatly complicate either the possibility for reform, or a flexible interpretation of, the SGP.[13]

Largely at the request of Germany, the European Council in 1997 unanimously adopted three pieces of legislation designed to clarify the excessive deficit procedure described in the Treaty and ensure that any such deficits were quickly handled. The three parts are the budgetary rules of the European Council and they form the actual Stability and Growth Pact.

The two most important rules of the SGP are the following:

- Member states commit themselves to adhere to the *medium-term* (as opposed to short-term) objective of maintaining a budget that is close to balance or in surplus as part of their stability or convergence programs.
- The rules allow member states to violate the budgetary provisions of the SGP in the event of a "severe recession," which is defined as a decline of 0.75 percent or more in real GDP.

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12. Blocking Council actions hence requires the votes of members representing more than 35 percent of the EU population. Three large countries alone cannot block actions. See ue.eu.int/igcpdf/en/o4/ea00086.en04 (accessed July 19, 2004).

13. See footnote 21 in this chapter.

According to the European Commission, the medium-term budgetary clause was added to the SGP for several reasons:[14]

- to allow member states to deal with normal cyclical fluctuations while keeping the government deficit within the 3 percent deficit limit. With the loss of exchange rate stabilizers in the EMU such automatic fiscal stabilizers were viewed with increased importance;
- to allow some member states to quickly reduce their total debt to GDP ratio, while preventing all member states from continuously adding to their total debt; and
- to ensure that member states factor in the fiscal implications of aging populations.

However, no operational definition for the medium target was given in the SGP (nor were any coercive measures of enforcement laid down). This led the European Commission to adopt a so-called minimal benchmark for assessing whether or not member states' budgets met the "medium-term close-to-balance or surplus" criterion. This minimal benchmark explicitly took only one factor into account—namely, the influence of fluctuations in economic growth on the government's budget.[15] It did not consider the differing needs of member states to reduce their total debt ratios,[16] their contingency plans for aging, or any other aspects of fiscal sustainability when assessing whether a given budget meets the "close-to-balance or surplus" criterion.

The budgetary surveillance program is to ensure that member states actually follow the budget rules. European Council Regulation No. 1966/97 presents "the rules covering the content, the submission, the examination, and the monitoring of stability programs or convergence programs"[17] as part of multilateral surveillance by the Council. Most important are the following provisions:

- Member states must present an annual stability/convergence program to the European Council and Commission covering the previous, present, and the future—with a minimum three-year projection.

14. These reasons are detailed in the European Commission's first report on the SGP (2000e, 61).

15. This measure of how much cushion automatic fiscal stabilizers would require to work, while keeping member states' deficits below 3 percent, is calculated by a combination of individual budget gap estimates and budgetary sensitivities to the cycle in member states (European Commission 2000a, 51).

16. That this is not the case, despite the fact that some member states still have total government debt figures above 100 percent, is an indication of how completely any debt-stock evaluation has been excluded from the SGP framework.

17. Member states that have adopted the euro present "stability programs" whereas member states that have not present "convergence programs."

- A stability/convergence program must include information regarding:
  - the medium-term objective of maintaining a budget that is close to balance or in surplus and the adjustment path toward this objective as well as the general government debt ratio;
  - the main assumptions about expected economic developments and relevant economic variables for the stability/convergence program;
  - a description of budgetary and other economic policy measures being taken and/or proposed to achieve the budgetary objective of the programs; and
  - a sensitivity analysis of the stability/convergence program to changes in main economic assumptions.
- The European Council, on the recommendation of the European Commission, examines the submitted stability/convergence programs, and if it judges that a program requires strengthening, the Council will "invite the member state to adjust its program."
- In the event of a significant divergence of a member state's budgetary position, or from its medium-term objective of the path toward it, the Council will give an early warning in order to prevent an excessive deficit.
- If subsequent monitoring finds that the budgetary position of a member state has not improved compared to its medium-term objective, or if the path toward it is persisting or deteriorating, the Council will make a recommendation to the member state to take prompt corrective action and may make this recommendation public.

The next step in the process involves coercive measures and penalties on member states that do not follow the rules—notably any violation of the 3 percent deficit rule. European Council Regulation 1467/97 Article 1 states "the provisions to speed up and clarify the excessive deficit procedure, having the objective to deter excessive general government deficits and, if they occur, to further their prompt correction." As noted earlier, the Council can impose a very stiff sanction, in the form of noninterest-bearing deposits of 0.2 to 0.5 percent of the member state's GDP—on a member state that has not implemented the corrective measures recommended by the Council. In addition, annual Council evaluations of a member state's progress toward eliminating its excessive deficits are carried out, and if the deficits have not been eliminated, further annual noninterest-bearing deposits of 0.2 to 0.5 percent of GDP may be levied. If the excessive deficit has not been corrected after two years, the deposits are converted into a fine, together with all its interest revenue, which is distributed among member states according to their respective proportion of total GNP.

There are some allowable exceptions to the excessive deficit procedure and variations in the procedures that lead up to imposing fines.

- An excessive general-government deficit is considered exceptional and temporary if it is caused by an unusual event outside the control of the member state, or if the European Commission budgetary forecasts predict the deficit will fall below the reference value at the end of the unusual event.[18]
- Up to a year can pass from the time the European Council declares that a member state has an excessive deficit before it imposes a sanction.
- Council decisions can be changed by a new unanimous decision by the European Council, which makes them significantly easier to reform than regulations included in the EU Treaty.
- There are no coercive measures attached to the objective of achieving medium-term budgetary balance or surplus. The only implicit sanction the European Council can "impose" is to make public its recommendations for a member state to rectify a deviation from its stability/convergence program.[19]
- The European Council's coercive measures against member states are related only to the annual 3 percent deficit ceiling and not to the 60 percent government debt reference value.
- The European Council annually evaluates a member state for three years before fines must be paid. (Thus, the fines might not actually be levied.)

To summarize, changing either the formal rules of the SGP or the 3 percent and 60 percent reference values is virtually impossible. However, there is substantial leeway in the system to allow a country that violates

18. In making this decision, the European Commission typically regards a 2 percent or more decline in GDP as a severe economic downturn. However, the European Commission must consider any observations made by the member state indicating that a fall of less than 2 percent is exceptional. In other words, the member state may be able to convince the European Commission that a decline of only 0.75 percent of real GDP is a severe downturn. As noted earlier, the implicit lowering of the threshold for a severe economic downturn from 2 percent to 0 .75 percent in the 1997 European Council Resolution on the SGP was crucial for its existence.

19. The lack of coercive measures attached to the stability/convergence program may have facilitated the ease with which France, Italy, and Germany secured repeated extensions of the deadline for their general government budgets to meet the "close-to-balance or surplus" criterion.

the rules to go unpunished, if the other countries are unwilling to enforce the system.

At the meeting of the ECOFIN Council on November 25, 2003, the political unwillingness of member states to enforce the rules of the SGP was highlighted. France and Germany, despite forecast breaches of the 3 percent deficit ceiling for three years running (2002–04), were able to avoid the initiation by the European Commission of corrective budgetary measures. The two countries had already been given an extra year, until 2005, to bring their deficits below 3 percent, provided they took steps to show how they would get back on track. However, the two countries failed to take those steps, and the European Commission asked the ECOFIN Council to allow them to initiate a sanction process (as required by the SGP). The proposed 2004 budgetary remedies consisted of cuts to the cyclically adjusted deficit in France by 1 percentage point of GDP, and 0.8 percentage point in Germany. However, the ECOFIN Council voted not to initiate the process and, without Council support, the Commission's recommended sanctions lack legal force.

While the political fallout from this apparent breakdown of the SGP is likely to be huge, with large member countries pitted against smaller member states (and the ECB),[20] it is not clear that the direct economic impact will be that big. While the European Commission could not get majority support in the ECOFIN Council for its suggested sanctions, a majority of the ECOFIN Council did support an Italian compromise proposal. According to the compromise, France must cut its cyclically adjusted deficit in 2004 by 0.8 percentage point of GDP and Germany its cyclically adjusted deficit by 0.6 percentage point, and both countries must reaffirm their promise to bring their deficits below 3 percent in 2005—economic conditions permitting. However, the ECOFIN Council's ability to enforce these promises seems improbable so their fulfillment rests solely on the political will of the French and German national governments, rather than on the rules-based approach laid down in the SGP.[21]

20. It is notable that many smaller countries (but now also Britain and France) must put a new European Constitutional Treaty to a referendum, and it seems likely that their electorates will respond negatively to the perception of *some being more equal than others* before EU law.

21. In mid-January 2004 the European Commission challenged the legality of the ECOFIN Council's action on November 25, 2003 to suspend coercive measures against France and Germany for nonadherence to the SGP. See *Financial Times,* "Legal Move Threatens to Reignite Europe's Conflict over Fiscal Rules," January 8, 2004, page 1, and *Financial Times* "Brussels Insists on Legal Challenge over Pact," January 13, 2004. Such a lawsuit is unprecedented in EU history, but not wholly unexpected. On July 13, 2004, the ECJ delivered a "Solomonic verdict" that allowed both the European Commission and the ECOFIN Council to claim victory. The ECJ ruled that the ECOFIN Council is solely in charge of deciding whether or not to impose sanctions on member states, i.e., it does not have to follow the recommendations of the European Commission. On the other hand, the ECJ agreed with the European Commission that the ECOFIN Council acted illegally on November 25, 2003, when it put the threat of sanctions

Fiscal Policy Leading Up to and after the SGP

The fiscal constraints embodied in the SGP originated as part of the convergence criteria for admission into the eurozone[22] and were laid down in the Maastricht Treaty in 1992. They have remained unchanged in subsequent revisions of the EU Treaty.

As can be seen in figure 6.1 significant progress was made in the 1990s by all EU members toward achieving the 3 percent deficit goal ahead of the 1997 deadline for adopting the euro. Figure 6.2 shows that the countries with the highest debt levels were stabilizing those levels and starting to reduce them. However, some EU members who wanted to join the euro area[23]—principally Italy, Belgium, Ireland, and Greece—were in substantial violation of the condition that general government debt be limited to 60 percent of GDP by 1997 when the European Council decided who could enter the euro area in 1999.[24] This obviously presented the European Council with a terrible dilemma, since it was seen as politically inconceivable to launch the euro without either Italy—the sixth largest economy in the world and a founding member of the European Union—or Belgium—the headquarters of the main EU institutions and another founding member of the European Union.

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into abeyance, without being prompted to do so by the European Commission. The ruling means that no sanctions against member states will be forthcoming and that the uncertain status quo continues. Regretfully, much time at a precious time, where the SGP could have been reformed, has been lost for only a very minor procedural clarification by the ECJ. For our proposals for a revision of the SGP rules, please see below.

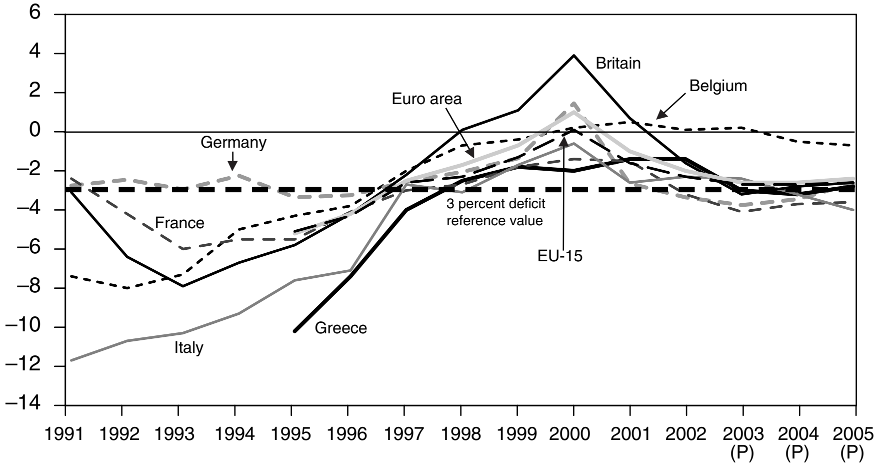
22. Apart from the 3 percent deficit and 60 percent debt ceilings, these criteria encompassed limits to inflation rates relative to the EU core economies as well as limits to how much a national currency could fluctuate within the European Monetary System. These criteria will be significant for new EU accession countries after May 2004. However, for purposes of this SGP discussion, only the 3 percent and 60 percent reference values are relevant.

23. Britain had opted out of parts of the Maastricht Treaty in 1992. Denmark opted out in 1993 following a referendum rejection of the Maastricht Treaty. Sweden has been unwilling to enter the third stage after joining the European Union in 1995, and its exact legal position is unclear since as a member state without explicit opt-out rights, it is in principle obliged to enter the third stage of the Maastricht Treaty. However, given Sweden's decisive rejection of the euro at the September 14, 2003 referendum, there is no chance of a near-term Swedish adoption of the euro and entry into the eurozone. Yet the European Council has not yet ruled on the issue. This impasses provides a possible indication of the status the new EU entrants from Eastern Europe will have in relation to the EMU third stage: They will be EU members, but not members of the EMU until there is domestic political will to adopt the euro, and they pass an EU political inspection that outlines their adherence to the fiscal SGP criteria.

24. Greece was unable to enter the eurozone in 1999 because of too high inflation levels relative to the other EU economies in 1997. The country subsequently adopted the euro in 2001. It is also evident from figure 6.1 that Italy achieved a remarkable fiscal improvement from a general-government deficit of 7.1 percent of GDP in 1996 to only 2.7 percent in 1997. It was widely discussed in the media and academic literature at the time that Italy was only able to achieve a deficit below 3 percent in 1997 via significant one-off accounting reallocations.

Figure 6.1 General government lending or borrowing, select EU members, 1991–2005

percent of GDP at market prices



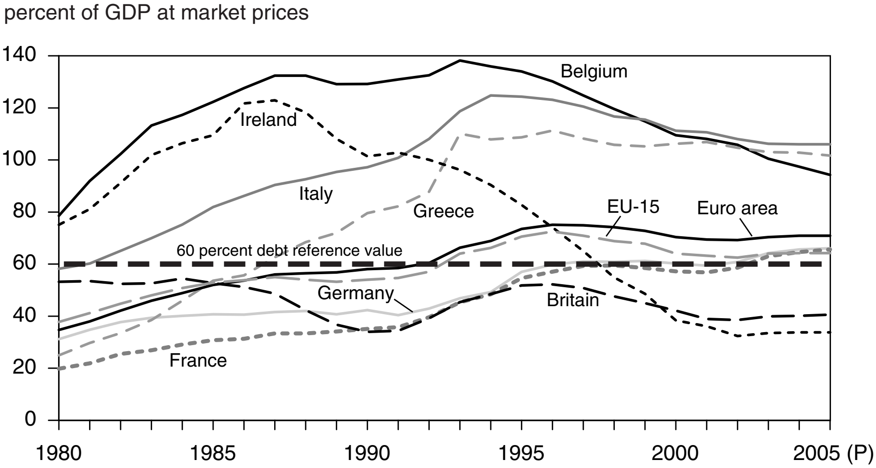
P = preliminary for 2003, projected for 2004–05.

Note: European System of Accounts 95, which includes one-off proceeds relative to the allocation of mobile phone licenses (UMTS), is as follows: In 2000: Germany € 50.8 billion, Italy €13.8 billion, and Britain £ 22.5 billion. In 2001: Belgium € 0.45 billion, Greece € 0.65 billion, and France € 1.24 billion. In 2002: France € 0.62 billion.

Source: European Commission (2004a).

As a result, the European Council decided effectively to annul the 60 percent reference value of general government debt. The general government-debt ratios of Ireland, Italy, and Belgium were ruled to be on a declining trajectory, and, hence, they were deemed eligible to join the euro area in 1999, despite the fact that the latter two's debt ratios in 1997 were both more than 120 percent of GDP. It is clear that Ireland's rapidly declining government debt ratio, down from about 100 percent of GDP at the time of adoption of the Maastricht Treaty in 1992 to just above the 60 percent threshold in 1997, provided a precedent for rapid declines in government debt-to-GDP levels. Also, the fact that the Belgian franc had maintained its de facto peg (together with the Dutch guilder) to the German mark from 1983 onward—despite the rapidly deteriorating Belgian government debt level—provided some indication that monetary stability was possible, despite high government debt levels. However, both these cases seem idiosyncratic and poor economic examples upon which to base a complete waiver of the 60 percent government debt threshold. No one can realistically expect other European economies to experience the

Figure 6.2 General government consolidated gross debt, select EU members, 1980–2005



P = projected

Note: European System of Accounts as of 1996. Former definitions for earlier years, linked series.

Source: European Commission (2004a).

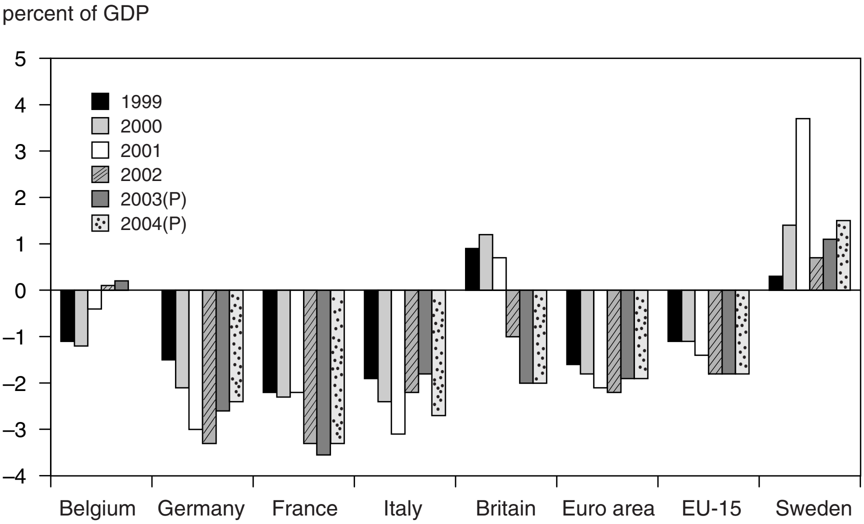
rapid catch-up in GDP seen in Ireland.[25] Obviously a purely political decision was made, based on the desire to include all willing European countries at the launch of the euro, to use the 3 percent deficit limit as the only binding constraint of the SGP.

Figure 6.3 shows that many EU countries did not make any further move toward budget balance once they had moved below the 3 percent threshold. Fiscal consolidation stalled at a deficit level between 1 and 2 percent of GDP, particularly among the large economies.[26] This contrasts with the improving trend in EU member-state budgeting seen in the 1990s and is significant because the SGP's intent was for countries not to quickly exceed the 3 percent limit when they encountered a period of slow economic growth. Countries were intended to operate at budget balance or surplus in normal times—leaving room for deficits in downturns without crossing the 3 percent threshold. Figure 6.4 clearly shows that by far the largest part of actual budget deficits, especially in the major continental

25. By not considering general debt levels, one also ignores the potentially very costly demographic changes.

26. Hallett, Lewis, and Von Hagen (2004) show forcefully how only smaller EU states have imposed fiscal discipline since 1999. They note that this is unfortunate as in smaller states "it matters the least" and suggest that big countries may think themselves "too big to fail."

Figure 6.3 Cyclically adjusted budget position of the EU member states, large EU economies, 1999–2004



P = preliminary

Note: Under the Stability and Growth Pact, the cyclically adjusted budgetary position of member states must be close to balance or in surplus over the economic cycle. The requirement does not apply to Britain, which has officially opted out of the euro, but it does apply in theory to Sweden even though it remains outside the euro.

Source: European Commission (2004a).

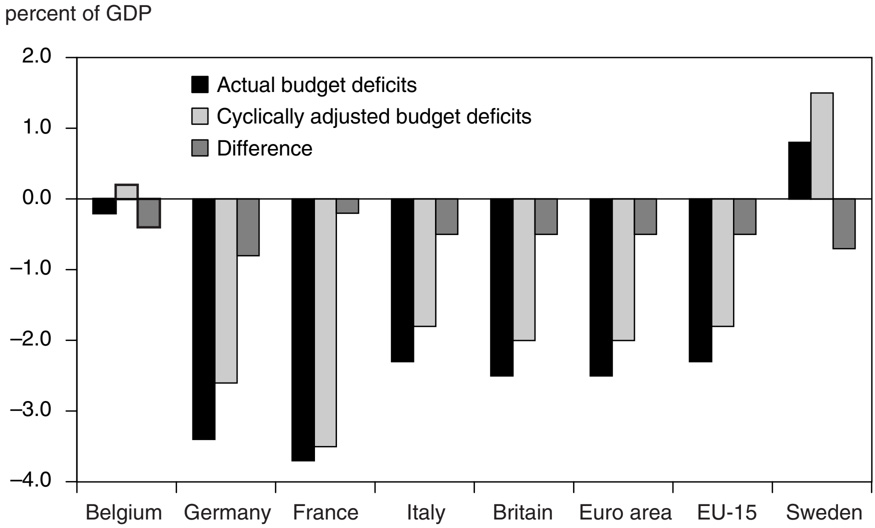
European economies, is structural in nature. For example, France's structural deficit is 3.5 percent of GDP, which is larger than the 3 percent deficit threshold—virtually ensuring a breach of the SGP at any time of economic slowdown.

Problems with the SGP

Buti, Eijffinger, and Franco (2003) have outlined what they see as the main criticisms of the SGP:

- There is a reduction of budgetary flexibility that makes it difficult to use countercyclical fiscal policy. It could even impede the automatic fiscal stabilizers, since taxes fall and government spending rises in downturns even without specific policy actions. This problem is particularly important since the euro has eliminated country-specific monetary policy as a stabilization tool.

Figure 6.4 EU member states' actual and cyclical budget position, 2003



Note: Under the Stability and Growth Pact, the cyclically adjusted budgetary position of member states must be close to balance or in surplus over the economic cycle. The requirement does not apply to Britain, which has officially opted out of the euro, but it does apply in theory to Sweden.

Source: European Commission (2004a).

- The SGP is asymmetrical, because it does not restrict a member state from increasing expenditures or cutting revenues during cyclical upturns.
- The SGP has a lot of "bark" with firm rules and large penalties, but it may lack "bite" since the sanctions are delayed and often unenforced.[27]
- Some countries (Britain is a current example) may wish to build or rebuild their public infrastructure. The SGP deficit ceiling is based on the assumption that capital expenditures are funded from current revenues, rather than spreading the cost over current and future generations.
- The SGP rules are country specific with no reference to the euro area as a whole.

27. Of course if the rules mandate a negative outcome, then the fact that sanctions can be evaded is perhaps welcome. But repeated violations of the rules will undermine the whole goal of enforcing long-term fiscal discipline.

- The focus on the deficit ceiling encourages creative accounting and one-off measures to avoid violating the rules in the short term. The stock of public debt and pension liabilities do not enter the SGP, and, given the huge differences among SGP members in these areas, could penalize a country that has sound, long-run policies and not penalize a country where the long-run fiscal situation is not sustainable. This inequality could discourage countries from implementing long-term reforms—such as pension reform that might raise fiscal sustainability in the long run—at the cost of short-term deficits.

The SGP's design was heavily influenced by the goal of establishing a stable common currency for the European Union. The history of the 20th century is replete with examples of countries whose currencies collapsed as fiscal discipline broke down, and the use of a printing press to print money to pay the government's bills. The countries joining the EMU—Germany in particular—wanted to ensure that the stability of the euro was not undermined by the threat of debt default by a member country. Even short of actual default, the member countries wanted to make sure interest rates would not rise in all countries as a result of fiscal problems in one country.[28] The parties to the SGP wanted to discipline not only each other but, more importantly, the countries that were expected to join the euro area in the future. Hallett, Lewis, and von Hagen (2004) point out that the SGP is clearly less effective as a disciplining tool for existing member states than the threat of exclusion from the eurozone before 1997.

Reform Proposals from Economists

The reform proposals from a group of economists including Wren-Lewis (2000), Wyplosz (2002a and b), and von Hagen (2002) can be grouped into five types.

Improving Enforcement

The first proposal focuses on enforcing SGP budget rules. Part of this economist-proposed solution involves the private sector. Banks in any EU economy would be required to hold no more than 25 percent of their capital in the obligations of their national government. OECD-country government debt would be given a positive risk weighting in a bank's portfolio, rather than a zero weighting, as is the case at present. Additional

28. This is the origin of the explicit "no bailouts" clause in the EU Treaty. Member states wanted to avoid the moral hazard of countries "too big to fail" that could possibly weaken market discipline.

aspects of the proposals look at government institutions, and the first suggestion is to elevate the standing of treasury ministers so they may overrule spending ministers during intragovernment budget preparation and limit parliament's ability to amend budgets. Furthermore, a fiscal policy committee would be created within each country and be given the task of setting fiscal policy targets. The fiscal policy committee's aim would be to deliver long-term fiscal sustainability and flexible short-term stabilization. The proposals would go beyond national governments to suggest a supranational body with the power to assess and sanction the budgetary behavior of national governments.

These proposals would be a nonstarter politically—notably the plan to elevate finance ministers or the creation of a technocratic body at either the national or supranational level with the power to overrule democratically elected parliaments. It would also be difficult to modify the SGP framework to incorporate revised Basel debt-risk weights. However, getting the private market to play a more active role in disciplining government borrowing does have merit. The idea of moving the responsibility for fiscal discipline back to the national level—where actual decision-making power (and legitimacy) lies—also has merit. These enforcement proposals are necessary since the EU peer-pressure mechanism has failed in fiscal policy. Holding national governments accountable could potentially be combined with increased technical oversight of government fiscal reporting, so as to limit the options for "one-off accounting measures" to improve government finances.[29]

Changing the Focus to the Long Run

The second set of proposals argue that the SGP's key problem is that it does not focus on the economy's long-run fiscal situation because of its

29. Deciding what items are recorded as government revenue/expenditure is one way "technocratic decision making"—with potentially large effects on EU member states' fiscal policies—already occurs. A recent example is from October 2003 and February 2004, where Eurostat took two decisions on the accounting treatment in national accounts of payments to governments by corporations in the context of the transfer to the government of the company's funded or unfunded pension liabilities. As several EU member states—notably France—retain sizable publicly owned enterprises (with company-specific pension plans) scheduled for future privatization, such transactions could have a significant positive effect on public finances at the time they occur, since such companies will pay the government a lump sum to shoulder their future pension responsibilities. Perhaps conveniently the European System of Accounts 1995 (and the National System of Accounts 1993) does not recognize the increase in future government-pension liabilities as a financial instrument, and the transaction, subsequently, has no effect on the level of government debt. See European Commission News Releases Stat 120/2003, October 21, 2003, and Stat 04/26, February 26, 2004. www.europa.eu.int/comm/economy_finance/news/pressreleases_en.htm (accessed March 3, 2004).

emphasis on the 3 percent rule (Mills and Quinet 2002; Brunila 2002; IMF 2001b; Fitoussi and Creel 2002). Two different and distinct plans to introduce long-run fiscal restraint without imposing a short-term deficit target are proposed.

The first plan simply suggests placing limits on public expenditure in relation to GDP. This approach claims that expenditure limits are more controllable than deficit limits and would allow the automatic stabilizers to work on tax revenue. Controlling spending, the argument goes, will limit the size of government and thereby prevent unstable fiscal policies from developing. However, this proposal would impose a single spending rule on individual countries, whose need for public expenditures may vary widely. There is no particular reason why a country that votes democratically to increase its public spending should be prevented from doing so as long as its citizens are willing to pay the cost (of course work-incentive problems may arise, but these too are a matter for each country to decide on). Moreover, with no explicit limit on deficits, the proposal would not prevent long-term deficit spending by countries that failed to keep tax revenues in line with the level of spending.

The second way to take into account the long-run fiscal situation is the "golden rule" proposal. Under the rule, borrowing would only finance public investment. This proposal would require a dual budget process to separate consumption and investment. The proposal would spread the burden of capital projects over the generations of all taxpayers that benefit from a capital project, and it would avoid efficiency losses due to fluctuations in the tax rate over time.

Reviewing this proposal, the European Commission and Buti, Eijffinger, and Franco (2003) argue that such a rule would have to refer to net spending (for example, all depreciation should be tax financed). They also note that the private sector can provide significant parts of the infrastructure, so the need for large public bond issues is not too large and could be accommodated within the current 3 percent deficit rule. However, creative accounting is a possibility if some forms of government consumption are classified as forms of investment.

In addition to the problems highlighted by the Commission, the "golden rule" proposal also does not deal with the issue of the automatic stabilizers, which would have to be addressed by a different reform.

Addressing the Fiscal Situation of the Euro Area as a Whole

Casella (2001) has argued that the current SGP does not address the fiscal situation of the euro area as a whole. She argues that maintaining confidence in the euro requires that the euro countries as a group avoid getting into fiscal problems severe enough to trigger inflationary pressures. She argues that if only one country exceeds the 3 percent rule, then there is no significant threat to stability. However, if all countries run deficits in excess of 3 percent, financial markets and investor confidence may be affected.

One approach to dealing with the euro area as a whole is to set up a supranational entity. This entity would allocate deficit shares among member states—allowing some to overshoot, while others remain in balance—to maintain the average of no more than 3 percent. A more flexible alternative, which minimizes the role of any supranational entity, would establish a system of tradable budget-deficit permits that allow individual members to deviate from the aggregate target in case of idiosyncratic shocks, by purchasing permits from surplus countries. Based on the success of tradable pollution permits, adding a market mechanism would minimize the aggregate costs of compliance and would reward surplus countries. Reducing the role of the supranational entity would also reduce the risk of political manipulation.

The European Commission and Buti, Eijffinger, and Franco (2003) note that setting deficit goals based on the euro area or the European Union as a whole would be difficult since the Maastricht Treaty would need to be renegotiated.[30] They also argue that since the debts of different countries are not perfect substitutes, their relative values would have to be defined, which would spark political controversy. (This argument does not seem compelling since treating all euro countries equally would be an ideal starting point for this proposal.) Finally they argue that there are not enough countries to establish a competitive market in deficit permits.

Making the Target Less Arbitrary and More Consistent with the Long Run

Buiter and Grafe (2002) argue that the SGP's critical issue is that the 3 percent deficit rule and the "close-to-balance" target are arbitrary and sometimes inconsistent with an appropriate fiscal stance. Further, the goals do not take into consideration the differences of each country. Thus, Buiter and Grafe's reform proposal is based on a "permanent balance rule" under which the inflation- and real-growth–adjusted permanent government budget is kept in balance or surplus. The permanent budget balance is defined analogously to the economic concept of permanent income and is based on the difference between the long-run average future values of tax revenue and government spending. The permanent balance rule would allow catch-up countries whose growth rates are higher to sustain higher current deficit levels than slower-developing countries. The rule would also allow the automatic fiscal stabilizers to operate, as long as the long-run fiscal situation of a country was sound. Depending on the time frame used for calculating the permanent balance, the rule would force

30. Currently, the 3 percent deficit reference values apply to each member state and cannot, without renegotiation of the EU Treaty, be applied at the aggregate eurozone level. See Buti, Eijffinger, and Franco (2003, 19).

countries to acknowledge the fiscal impact of future pension and health-care responsibilities.

This proposal has considerable intellectual merit, but it does not completely avoid being arbitrary, since there is no compelling reason from theory why the long-run budget should necessarily be exactly in balance or surplus. Presumably a target drawn from fundamental theory would be based on an optimal growth-and-accumulation framework, and would model the way in which a government's tax and spending decisions affect and are affected by private-saving decisions. Beyond this limitation, the authors' proposal adeptly shifts the focus away from the current deficit or surplus and toward a longer-term perspective and the ability of fast-growing countries to sustain larger short-term deficits (if they so choose).

The European Commission and Buti, Eijffinger, and Franco (2003) dismiss the proposal since it requires estimating permanent values for tax and spending. However, a dismissal seems too harsh. The US Social Security Administration carries out a procedure that is essentially the same as the one Buiter and Grafe propose when it issues its 75-year projections for the fiscal soundness of the Social Security system. Although these projections can change substantially and embody difficult projections of future productivity and inflation, they have, nevertheless, proved useful in evaluating the stability of the system.

Perhaps a more telling concern about the Buiter and Grafe proposal is that it does not focus on the issue that led to the SGP being created in the first place. Some member states were concerned about possible negative financial-market responses to excessive budget deficits and the danger that through the effect of the global capital market the euro could be undermined, or that interest rates in one country would be elevated as a result of deficits in another country. The European Commission argues, along these lines, that allowing rapidly growing countries to have high deficit ceilings risks instability at times of uncertainty, because of rapidly deteriorating credit worthiness and capital flight. In principle, the global capital market should be looking at the permanent budget balance in determining credit worthiness, but in practice its view may be more short term. After all, a country that has the potential to grow rapidly in the future may not in fact achieve that rapid growth.

Basing the Target on Debt Not Deficit

Pisani-Ferry (2002) and Hallett, Lewis, and von Hagen (2004) argue that fiscal sustainability depends on the stock of debt and not on the annual deficit. Like Buiter and Grafe (2002), this argument shifts the focus away from the current deficit as a target, but bases it on medium-term rather than long-term projections. Having a debt target is one way of capturing long-run sustainability that is less rigorous but easier to measure than estimates of the long-run budget balance.

Pisani-Ferry proposes that the SGP be supplemented with a debt sustainability pact, so that countries can opt out of the SGP deficit target in the short run if they present a comprehensive medium-term (5 years is suggested) fiscal program, indicating a debt ratio target below a given level (50 percent of GDP is suggested). These fiscal accounts would include estimates of the future effect of all budgetary commitments, such as pay-as-you-go pensions. The focus of EU monitoring would thus shift to the medium-term debt ratio targets, rather than annual deficits, thereby increasing short-term flexibility.

The European Commission and Buti, Eijffinger, and Franco (2003) raise similar concerns about this plan as those leveled at the Buiter and Grafe plan. They argue that estimates of future commitments and liabilities are highly uncertain, since estimates are subject to macroeconomic, demographic, and behavioral changes as well as being prone to political manipulation of budget commitments. The Commission also believes that current deficits matter to financial markets.

The European Commission's Reform Proposal for the SGP

The European Commission offered its own reform proposal for the SGP and sent it to the European Council and the EU Parliament on November 27, 2002.[31] The proposal was to be the basis for discussion at the spring 2003 European Council Summit, although the Council did not seriously consider SGP reform. The main aim of the European Commission's proposal is to introduce more flexibility into interpreting the SGP, while ensuring stricter adherence to the SGP's goal of sound and sustainable public finances. The changes to the SGP must be achieved *within the framework of existing Treaty provisions and SGP regulations* (European Commission 2002b, 6). Recognizing that the key to adherence to the SGP lies in member-state national budget politics, the Commission requested that the European Council renew its political commitment to the SGP.

The European Commission proposal includes four main elements:

Reinforcement of Budgetary Coordination Policies

- The "close-to-balance or surplus" requirement should be explicitly defined in underlying terms throughout the economic cycle—that is, net

31. Available at http://europa.eu.int/eur-lex/en/com/cnc/2002/com2002_0668en01.pdf. Following the ECOFIN Council decision on November 25, 2003, the European Commission announced that it will publish new proposals "aimed at maintaining and stepping up effective coordination of economic policies" in the fall of 2004. Unfortunately, these are not yet available at the time of writing (European Commission President R. Prodi, speech to the European Parliament, January 21, 2004, www.europa.eu.int/rapid/start/cgi/guesten.ksh?p_action.gettxt=gt&doc=SPEECH/04/31|0|RAPID&lg=EN&display= [accessed March 3, 2004]).

of transitory effects and including the effects of cyclical fluctuations on budgets.

- Member states with an underlying deficit should be required to achieve an annual budgetary consolidation of at least 0.5 percent of GDP.

Upgrading the Analysis of Economic and Budgetary Policies

- Member states shall improve the quality, transparency, timeliness, and reliability of budgetary statistics, and the European Commission shall use its own estimates to evaluate the feasibility of member states' macroeconomic assumptions.
- The European Commission will devote more attention to the quality of member states' public finances with regard to their potential for growth and employment, by focusing on the differences between tax increases and expenditure cuts, the impact of tax reforms, and the impact on consolidation of one-off budgetary measures.
- The European Commission will organize more comprehensive and frequent visits to member states and publish in-depth country studies that evaluate their economic and fiscal prospects.

More Effective Enforcement Procedures

- In accordance with the EU Treaty, inappropriate budgetary policies that move a member state's budget away from an underlying position of "close-to-balance or surplus"—including procyclical loosening of the budget in prosperous times—should be viewed as a violation of the budgetary requirements at the EU level and lead to coercive measures.
- Clarification of what constitutes a satisfactory pace of debt reduction toward the 60 percent of GDP target—accompanied with the real possibility of coercive action against offending member states—is needed.
- The European Commission, rather than the ECOFIN Council, should be given the right to issue early warnings to member states.

Better Communication Through Openness and Transparency

- The European Commission would make public its detailed assessments of member states' stability/convergence programs as well as the quarterly (rather than biannual) reports on the member states' fiscal positions.

The European Commission's proposals are less focused on the pure economics of an optimal SGP and more on how to improve the existing

SGP. Implementing this reform package would "simply" require a unanimous vote of the European Council, rather than a renegotiation of the EU Treaty or any change in national legislation. By introducing the concept of the "underlying" deficit, which is comparable to the so-called structural deficit, the proposals allow for cyclical variations in the deficit rules. Beyond this, however, the proposals strengthen the deficit rules and attempt to speed up the process of reaching "close-to-balance or surplus" budgets in all member states.[32] Adding a debt-to-GDP target would make it extremely difficult for countries with high initial debt levels, like Italy, to meet these new requirements. Ineligibility could subsequently cause countries to deny any SGP reforms since any changes must pass a unanimous vote of the European Council. As the proposal stands there is too much that is punitive relative to any increase in flexibility to make it attractive to all the members.

While it is desirable to compel member states to face up to their fiscal problems and determine ways to resolve these problems, it is not desirable to force massive fiscal adjustment—with contractionary effects—on high-debt countries at a time of global economic weakness.

Modifying the European Commission Proposals

The ideal SGP would involve policies that provide sufficient flexibility to allow individual countries to use fiscal policy aggressively in a countercyclical fashion, since country-specific monetary policies are no longer available to euro members. The ideal SGP would also place tough policy constraints on member states that might otherwise be unwilling to follow budget plans that were sustainable over the long run. Ideally, these changes would be politically feasible and require only a modest revision of the existing SGP framework. Unfortunately, it seems that no comprehensive set of policies meet all of these criteria. Therefore, the only feasible SGP reforms—given the institutional constraints—are actually the second or even third best options, relative to the ideal.

Given this, what compromises will make reform of the SGP both feasible and as effective as possible? Evidence from the United States suggests that discretionary fiscal policy is generally not very adept at stabilizing the economy (Taylor 2000).[33] However, the automatic stabilizers *are* very

32. The proposed reform would halt or even reverse the 2002 extensions granted to Germany, France, Italy, and Portugal. Under the current SGP ruling, the countries have until 2006 to achieve close to balance or surplus in their budgets.

33. The 2001 and 2002 tax cuts do seem to have contributed to economic recovery in the United States. They were motivated primarily by the Bush administration's desire to cut taxes and were initially proposed during the 2000 election campaign—well before the economy entered a downturn.

effective, because they do not require policymakers to predict the business cycle and time their actions in a countercyclical fashion. SGP reform, therefore, should follow the proposal of the European Commission and several of the economists by allowing for cyclical variability of the deficit.

- The deficit target should be based on the underlying or structural deficit. Although setting a rule that the structural deficit should not exceed 3 percent of GDP is arbitrary—as Buiter and Grafe point out—it is reasonable. The 3 percent reference value is high enough to allow countries to rebuild aging infrastructures and low enough to keep the debt to GDP ratio down.
- The European Commission proposal to force structural-deficit countries to make a 0.5 percent of GDP annual adjustment should be softened or removed in order to avoid requiring a country to raise taxes or cut spending in a downturn (see below for more on long-term budget issues).

We support the proposals by the European Commission and the economists that focus more attention on the long-run sustainability of the budget plans of member countries. However, we are concerned that too mechanical an application of a debt-to-GDP target ratio could force countries to maintain tax rates that are excessive. *Getting the macroeconomics right should not undermine the effort to improve work incentives.* As the US experience over the past ten years amply illustrates, the best way to deal with budget deficits and rising debt is rapid economic growth, while sustained economic weakness quickly turns surpluses into deficits.

Although the European Commission recognizes this point in its reform proposals—noting that budget policies should be evaluated with respect to their growth consequences as well as their deficit and debt consequences—they do not really follow through on it. When deciding what constitutes a satisfactory pace of debt reduction for countries that currently exceed the 60 percent target, the Commission does not take into account the possible adverse effects of remedial measures on microeconomic incentives. Italy, for example, has a very high starting value for its debt and faces a huge demographic challenge. It will be hard enough for Italy to keep its debt ratio stable, never mind bringing it down quickly to the target level. Rapid increases in payroll taxes, for example, could induce large reductions in employment.

We are less concerned than the European Commission that budget problems in one country could lead to a collapse of the common currency. The euro is now well established and could sustain shocks, even the shock of, say, Italy's departure from it. The situation of the euro today is different from when it was first introduced. For example, capital markets can distinguish between German government bonds and Italian government bonds, and they can and do introduce a risk premium in one asset and not the other. While the spillover costs of high deficits in Italy to Germany are not zero, they are also not too large.[34]

- The European Commission's plan to introduce its own budget-monitoring program to provide independent information about the short-term and long-term fiscal positions of member countries should be supported. Member states should be confronted with unbiased estimates of their true fiscal situation, as an auditing device (see also footnote 29).
- Draconian measures to quickly reduce debt ratios would be counterproductive for individual EU states and the EU economy overall. The sustainability of budget plans should be assessed over at least a 10-year horizon (preferably longer). These long-term budget plans should include meaningful and quantitative targets. Shorter time horizons for fiscal consolidation can lead to policies that exacerbate the business cycle, while simultaneously neglecting the medium- or long-term demographic challenges countries face.

Overall, we support the spirit of the European Commission's proposals, but we would modify their plan to allow even greater short-term budget flexibility. If Europe successfully carries out microreforms that enable it to grow more rapidly, short-term job disruptions will inevitably occur. It would be a tragedy if budget policy targets forced a sharp decline in aggregate demand and made it more difficult to reemploy workers who are forced out of their current jobs. In order to avoid this problem, the debt insolvency risk of individual EU countries should not be overemphasized. As we noted earlier, faster economic growth is the best way to solve budget problems. In addition, the modifications we have suggested would make it easier to pass the proposed reforms in the European Council.

More flexible SGP rules still require effective enforcement mechanisms. The sanctions for noncompliance with SGP rules must be reformed, since recent experiences have clearly found them ineffective. The European Commission's limited proposals in this area, which call for clearer definitions of when the Commission shall activate existing early warning mechanisms through existing instruments, are inadequate. Ultimate decision-making responsibilities for imposing fines on member states should remain with the elected politicians in the ECOFIN Council, but foreseen fines are so draconian that serious doubts emerge as to their actual application.[35] Also, the idea that member states should face fines that would

34. The Standard & Poors downgrade and Italy's debt in July 2004 did not have much effect on the other countries that joined the euro area.

35. This would cause the effectiveness of SGP rules in altering member-state behavior to wane. A quantification of risk must always consider the magnitude of the potential loss (for

aggravate already poor government finances is counterintuitive and is comparable to assisting a drowning person with a dumbbell.

Instead a number of different coercive measures of gradually increasing severity should potentially be available to both the European Commission (with limited power for milder sanctions) and the ECOFIN Council. Having an arsenal of different sanctions would greatly facilitate sound fiscal policies in prosperous times. Milder sanctions—including loss or postponement of EU structural funds or other transfers for particular projects in the country[36] or loss of the country's voting rights in some, or all, of the sectoral Council of Ministers—could be applied to countries disobeying rules prior to levying harsher penalties. These measures are more likely since they are less costly and do not require time-consuming revisions in the EU Treaty. In fact, these changes—political will providing—could be speedily enacted by the European Council itself. Furthermore, domestic pressure from groups directly affected by the sanctions could urge member governments to enact budgetary consolidation in the offending country.

Getting the Macroeconomics Right: The ECB Mandate and Its Stated Goals

The European Central Bank (ECB), which was created on January 1, 1999, has been charged with managing European monetary policy as outlined by two EU Treaty articles:[37]

- EU Treaty Article 105.1 states that the primary objective of the ESCB [ECB][38] shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community as laid down in Article 2.

example, the billions of euros in fines) and the probability that the event (for example, whether the ECOFIN Council will levy fines on offending countries) will occur. Even if the potential for levying fines is very high, the risk is limited if the probability of actually applying the fines applied is very low. Since the decision to apply fines is ultimately political in this example, it is evident that the two conditions are inversely related. Research by Adam Posen (2004) suggests that the SGP has had no discernible effect on eurozone member-state fiscal policy responses to fluctuations in GDP growth.

36. To provide incentives for compliance, project support could initially be frozen..

37. As is the case with the SGP, the EU Treaty articles concerning the ECB are included virtually unchanged in the Provisional Treaty Establishing a Constitution for Europe (Articles III-77 to III-87).

38. The European System of Central Banks (ESCB), which lists the ECB in Frankfurt first, incorporates all central banks in the eurozone.

- EU Treaty Article 2 states that the Union sets itself the following objectives: to promote throughout the Community a harmonious and balanced development of economic activities, sustainable and non-inflationary growth, respect the environment, a high degree of convergence of economic performance, a high level of employment and of social protection, the raising of the standard of living and quality of life, and economic and social cohesion and solidarity among member states.

Thus, the ECB's mandate primarily emphasizes price stability though it also places secondary emphasis on sustaining and supporting economic growth, provided this does not jeopardize price stability. The reasons for placing primacy on price stability were given in the ECB's inaugural January 1999 policy outline,[39] which lists the following four principal benefits of price stability:

1. Price stability improves the transparency of the *relative price mechanism,* thereby *avoiding distortions* and helping to ensure that the market will *allocate real resources efficiently* across use and time. A more efficient allocation will raise the productive potential of the economy. In this sense, price stability creates an environment in which the necessary structural reforms implemented by national governments to increase the flexibility and efficiency of markets can be most effective.

2. Stable prices *minimize the inflation risk premium* in long-term interest rates, thereby lowering long-term rates and helping to stimulate investment and growth.

3. If the *future price level is uncertain, real resources are diverted to hedging* against inflation or deflation, rather than being put to productive use. Credibly maintaining price stability avoids these costs and provides the environment for efficient real-investment decisions. Price stability also eliminates the real costs entailed when *inflation or deflation exacerbates the distortionary effects of the tax and welfare system* on economic behavior.

4. Maintaining price stability *avoids the large and arbitrary redistribution of wealth and incomes* that arises in inflationary as well as deflationary environments, and therefore helps to maintain social cohesion and stability.

The ECB then concludes that these arguments collectively suggest that maintaining price stability in itself contributes to the achievement of output or employment goals. The logic underlying both the Treaty and the euro system's stability-oriented monetary policy strategy is thus that out-

39. ECB, *Monthly Bulletin,* January 1999.

put and employment goals are best served by a monetary policy that focuses on price stability.[40] This conclusion, together with statements from ECB officials,[41] strongly suggests that the ECB sees no conflict between the goals of price stability on the one hand and employment and growth on the other.

The EU Treaty explicitly grants the ECB independence to define its own monetary policy target (Article 110), so in January 1999 the ECB adopted a quantitative definition of price stability based on "a year-on-year increase in the Harmonized Index of Consumer Prices (HICP) for the euro area of below 2 percent."[42] In order to achieve this goal, the ECB designated a reference value of 4.5 percent for the growth rate of the broad money supply aggregate, M3, together with a broad-based assessment of the outlook for future price developments and the risks to its price stability definition in the euro area. On May 8, 2003, the ECB Governing Council confirmed its original monetary policy strategy. However, the ECB then added *a lower threshold for inflation* clarification:

> At the same time, the Governing Council agreed that in the pursuit of price stability it will aim to maintain inflation rates close to 2 percent over the medium term. This clarification underlines the ECB's commitment to provide a sufficient safety margin to guard against the risks of deflation.[43]

Furthermore, the ECB explicitly states that it believes this clarification sufficient to ward off any adverse effect from "the implications of inflation differentials within the euro area"[44]—in other words, if inflation in the euro area as a whole is kept close to 2 percent, then no single country in the eurozone is expected to experience deflationary pressure. So far this precautionary measure seems to have successfully warded off deflation. In May 2003 only Germany came close to deflation with a year-on-year increase in prices of only 0.6 percent (Eurostat 2004a).[45] A monetary envi-

40. ECB, *Monthly Bulletin*, January 1999, 40.

41. For instance, see Duisenberg's testimony and other testimonies, Hearing before the Committee on Economic and Monetary Affairs of the European Parliament, December 2001, www.ecb.int/key/key.htm. See also Issing et al. (2001) and Truman (2003, 123–34).

42. ECB Press Release, "The ECB's Monetary Policy Strategy," May 8, 2003.

43. ECB Press Release, "The ECB's Monetary Policy Strategy," May 8, 2003. See also Truman (2003) and ECB (2003a) for a review of the ECB policy.

44. ECB Press Release, "The ECB's Monetary Policy Strategy," May 8, 2003.

45. Germany has consistently had the lowest inflation rates in the eurozone with only 0.9 in June 2003 and 0.8 in July 2003. Austria, Belgium, and Finland experienced 0.9 percent inflation in May 2003, May 2003, and October 2003 respectively, and are the only other countries in the eurozone to experience year-on-year inflation below 1 percent since the ECB's May 2003 statement.

ronment without deflation is, however, hardly sufficient to qualify as successful monetary policy.

In May 2003 the ECB announced that monetary policy decisions would henceforth be based on a two-pronged approach: economic analysis to identify short- to medium-term risks to price stability, and monetary analysis to assess medium- to long-term trends in inflation. This monetary analysis takes into account a wide range of monetary indicators, including M3. As such, retaining the quantity of money as an indicator of monetary conditions is no longer a target per se. Rather the money growth target now "mainly serves as a means of cross-checking, from a medium- to long-term perspective, the short- to medium-term indications coming from economic analysis."[46] Subsequently, the M3 reference value of 4.5 percent growth, while not completely discarded, has been given a much less prominent stature in ECB monetary policy, and its validity will no longer be annually reviewed.

External Assessments of What the ECB Has Actually Done

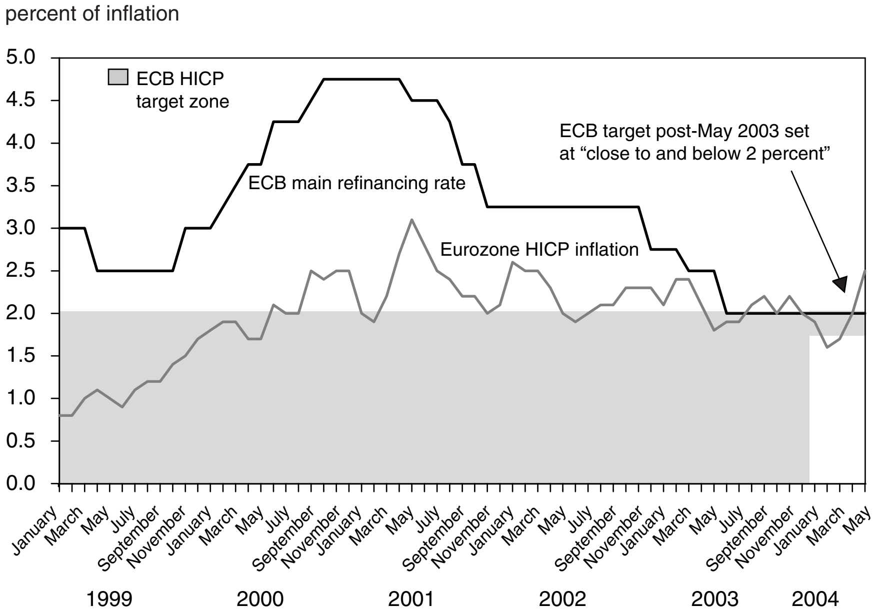
Meeting Its Own Targets

The ECB has been heavily criticized for its choice of goals and the monetary target it set to achieve these goals—notably the low target rate of inflation (less than but close to 2 percent growth for the HICP) and the money growth target (M3 growth of 4.5 percent), both of which were in place until May 2003. Has the ECB actually achieved its goals for price stability? Apparently not. Figure 6.5 clearly indicates that the ECB did not maintain HICP inflation below 2 percent a year prior to May 2003. In only about a third of the period from January 1999 to May 2003 (20 months of the 53 months from January 1999 to May 2003—and only for three months from May 2000 to May 2003) did the ECB succeed in reaching its own goal. During May 2003–May 2004 (data for May 2004 are preliminary at the time of writing), the HICP was between 1.6 and 2 percent for seven months, and the ECB can therefore reasonably be said to have been more successful recently. However, preliminary estimates of 2.5 percent HICP inflation for May 2004—up from 1.6 percent in February—bring these recent improvements into question (European Commission 2004a). All in all though, since actual eurozone HICP inflation has remained above the ECB target for most of the period since 1999, de facto monetary policy has been somewhat looser than stated ECB targets would suggest.[47]

46. ECB Press Release, "The ECB's Monetary Policy Strategy," May 8, 2003.

47. If the ECB's focus on achieving its inflation goal "in the medium term only" was the reason behind this initial—relative to its own goal—loose monetary policy, then the results of recent months can be said to have vindicated this approach. This remains true despite the recent uptick in HICP inflation, as core inflation remained subdued at 2.1 percent in the most recent month of May 2004 (European Commission 2004a).

Figure 6.5 Eurozone inflation and ECB main refinancing rate, January 1999–May 2004



ECB = European Central Bank
HICP = Harmonized Index of Consumer Prices

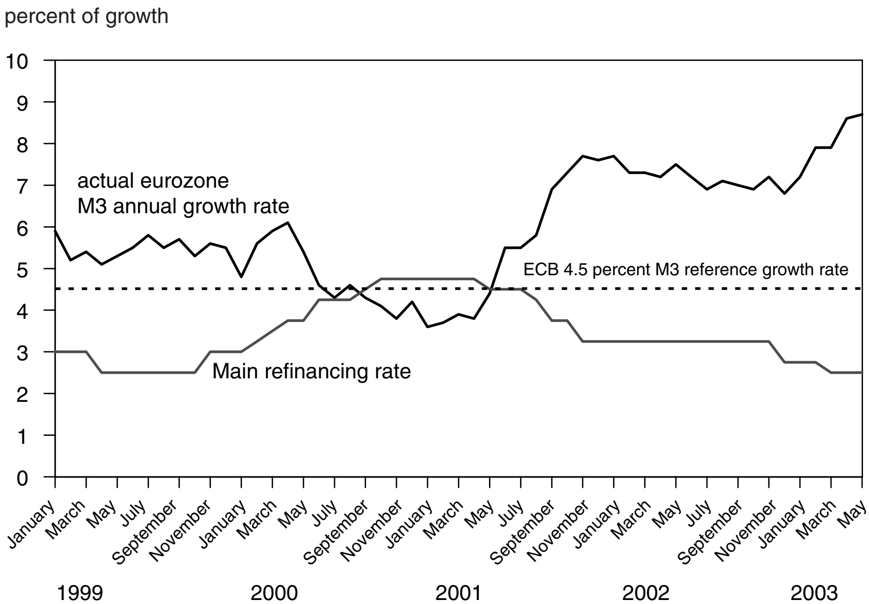
Sources: ECB Online Statistics, www.ecb.int (2001, accessed May 28, 2004); European Commission (2004a, 2004d); Key Indicators for the Eurozone, May 28, 2004, update, www.europa.int/comm.economy_euroindic_eu.pdf (accessed May 29, 2004).

The ECB also failed to accomplish its second goal of an annual M3 growth rate of 4.5 percent (figure 6.6).[48] Only 45 percent of the time (24 months out of the 53 between January 1999 and May 2003) has the ECB been able to achieve M3 annual growth of ±1 percentage point of its stated reference value. As all cases outside the ±1 percentage point band were above 5.5 percent annual growth, the ECB's actual monetary policy has been significantly more accommodating than its own reference values would indicate.

In the case of inflation, which is the more important target, the case can be made that the ECB was looking forward and was able to foresee that price inflation would be moving toward the target value over time, as indeed it did from mid-2001 on. In terms of the money-growth target, how-

48. Until mid-2001 the ECB warned that its M3 calculations were biased upward, since it included nonresident holdings of money market funds, liquid money, market paper, and securities. However, all these holdings were finally removed as of October 2001, so the updated ECB data are presented in this book.

Figure 6.6 Eurozone M3 annual growth rate and ECB main refinancing rate, January 1999–May 2003



ECB = European Central Bank

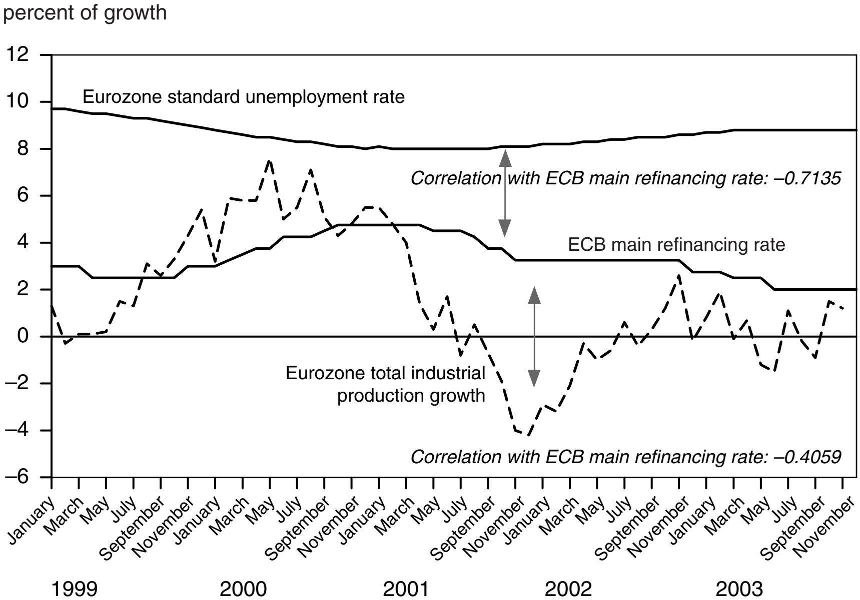
Source: ECB Online Statistics (2000), www.ecb.int (accessed May 29, 2004).

ever, figure 6.6 shows the M3 annual growth rate well above the target rate while the ECB refinancing rate was being lowered. Hence, the May 2003 clarification of the ECB monetary policy strategy, which raised the threshold for inflation and relegated M3 growth to secondary importance, can be said to bring stated ECB monetary policy more in line with actual policy.

One view of the ECB's behavior is that it has adopted a "publicly hawkish" inflation stand, while in reality its decisions consider growth and employment as well as other real economy variables. There is a large gap, in this view, between what the ECB says and what it does. In this, the ECB would apparently be following in the footsteps of the German Bundesbank, which, between 1973 and 1999, allowed its numeric monetary targets to be frequently breached in order to accommodate both foreign-exchange movements and German economic growth considerations. Publicly, however, the German Bundesbank preserved its reputation as an unbending inflation fighter (Clarida and Gertler 1996; Clarida, Gali, and Gertler 1997).

A detailed analysis of the ECB responsiveness to real economic indicators is beyond the scope of this book (see Truman 2003 and Posen 2004). But figure 6.7 does seem consistent with the view that the ECB has been influenced by growth and employment developments in its policy deci-

Figure 6.7 ECB main refinancing rate and selected economic indicators, January 1999–December 2003



Note: Correlations are simple pairwise Pearson correlations, statistically significant at a 99 percent level.

Source: ECB Online Statistics, www.ecb.int (accessed May 29, 2004).

sions. Movements in the refinancing rate are correlated (with the appropriate sign) with movements in euro area unemployment and industrial production.

The CEPR Assessment

The Centre for Economic Policy Research (Begg et al. 2002a,b) analyzed ECB policy and attempted to answer the hypothetical question: What would European monetary policy in 2001 have been if the US Federal Reserve (Fed) had been setting European interest rates, based on estimates of the Fed's "reaction function" or Taylor Rule[49] for policymaking?[50] The

49. Originally proposed by John Taylor (see, for instance, Taylor 1993), the rule proposes that real short-term interest rates be set according to (1) where actual inflation is relative to where a central bank wants it to be, (2) where economic activity is relative to the "full employment level," and (3) what level of short-term interest rates would be consistent with full employment.

50. The CEPR actually estimated the rule that best fit the Fed response to changes in various economic variables during Chairman Alan Greenspan's tenure and then applied this descriptive device on eurozone economic news in 2001.

CEPR concludes that European interest rates in 1999 and the first half of 2000 would have been up to one percentage point higher than those actually set by the ECB, while in the latter part of 2000 and 2001 the ECB and Federal Reserve would have set roughly similar interest rates. In addition, they found that a Taylor Rule for the ECB that weights both inflation and GDP growth tracks the actual policy decisions that were made. This further indicates that the ECB considered other macroeconomic variables rather than exclusively focusing on reducing HIPC inflation to below 2 percent a year at the time.

Of course even if the ECB follows the same policy approach as the Fed, there is no guarantee that the monetary policy in Europe will be a good fit for any individual member state in the euro area. After all, although diverse, the United States has the advantage of a more closely integrated market and greater labor mobility when dealing with such heterogeneous outcomes. The ECB faces a tougher problem than the Fed in trying to set monetary policy that is appropriate for both a main economic power like Germany and the peripheral countries of Europe. Such is the cost of a single currency.

Is the ECB Following the Right Monetary Policy?

The two issues at stake are (1) the use of inflation targeting as a goal for monetary policy and (2) the appropriateness of recent ECB policy responses to the economic downturn in the eurozone. It seems clear from the above that neither the ECB nor the Bundesbank were or are "pure" inflation targeters. They looked at the real economy when making their decisions, and not just at inflation. As Truman (2003) has pointed out, however, a thoughtful inflation targeter will take the real economy into account, since understanding it will provide important guidance on the future path of inflation. But given the persistent deviation of actual inflation from the target level, it seems as if the ECB has willingly violated its stated goal of putting price stability first and foremost, and has included real economy performance as a goal, and not just as a result of price stability. The ECB has not behaved as a pure or even semipure inflation targeter, but has traded off real growth against inflation.

The Euro and the Need for a Higher Inflation Target

It is just as well that the ECB violated its own rules, since the goal of pushing overall eurowide inflation below 2 percent was a bad choice. The ECB's arguments for price stability are not well supported by empirical analysis. In fact, empirical evidence finds little support for adverse effects on real growth from inflation, provided the rate stays below 5 percent a year (see

Truman 2003, 25). We do not advocate letting inflation go as high as 5 percent under normal circumstances, but the goal of keeping inflation close to 2 percent is too stringent. Thus, the ECB should allow a rate of inflation in Europe that is a bit above its current stated goal.[51]

Akerlof, Dickens, and Perry (2000) point out that in an economy where prices and wages are sticky downward, the economy will benefit from positive overall inflation. Real wages of workers, whose market position has deteriorated, can decline without forcing the contentious downward adjustment of nominal wages that can require prolonged high unemployment or job loss. The issue is not just with relative wages. If periods of sharply rising commodity prices are accommodated with a short burst of overall inflation, broad declines in real wages, which are a necessary response to the changed supply conditions, are induced. This pattern occurred with the oil and food shocks of the 1970s, although the resulting burst of inflation was too large and too extended.

In the euro area, the argument for significant positive inflation holds even more strongly than in the United States. The euro area countries have eliminated the adjustment of their relative exchange rates, which means that idiosyncratic shocks to individual countries may require the adjustment of relative price levels. Currently, Germany is undergoing a difficult price-level adjustment, having entered the euro at a value that was above its long-run sustainable level. *It is much easier to generate a downward adjustment in the relative price level of one country if the price levels of the other countries are rising*. The adjustment can then be achieved by, say, letting Germany have a lower rate of inflation than the EU average.

What if Britain were to enter the euro area? Currently, Britain receives a substantial foreign exchange benefit because it produces its own oil. When that oil runs out, Britain will have to bring about a substantial downward adjustment of its price level in order to ensure that its manufacturing sector becomes more competitive. Even though the labor market in Britain is more flexible than in the past, this would still require an extended period of slack demand.

Having an inflation target of close to 2 percent (but not below) might not in itself be such a problem if the ECB were willing to act more aggressively on a short-term basis to deal with, for example, a very weak European or world economy, or to respond to unexpected events such as oil price or other supply shocks. Unfortunately, actual ECB policy over the past few years does not indicate such a willingness.

51. One may argue that the phrase *close to 2 percent* leaves significant room for a flexible interpretation—for instance, it could mean up to 2.5 percent. However, such an interpretation would certainly be counterproductive for the ECB, since it would only serve to undermine the credibility of its stated policy goals and sow confusion in financial markets. It would be wiser to publicly state that the inflation target was in fact 2.5 percent.

How Good Has the ECB Policy Been During the Recent Downturn?

The second issue in assessing the ECB is whether it has done a good job or not—regardless of whether it followed its own rules. We disagree with the CEPR assessment that the ECB did just as well as the Fed in steering the economy. Fitting Taylor Rules can lead to mischief when interpreting past monetary policy. Most of the time a reasonable Taylor Rule will track actual Fed policy, which is unsurprising given the way time-series macro-variables are related. But a Taylor Rule does not always illustrate well what policy should be out of sample or in an unusual situation. For example, Alan Blinder reports that, while vice chairman of the Federal Reserve (1994–96), he asked the staff to estimate various Taylor Rules and many of them had an excellent fit to past data and policy choices. However, the different specifications gave very different prescriptions about the desirable future path of interest rates.[52] Thus, the answer you get from a given Taylor Rule depends on the exact specification used.

This point is illustrated and strengthened in an analysis by Goldman Sachs (2003). This study shows how actual monetary policy in the United States has sharply deviated from a Taylor Rule prediction over the past few years. The Taylor Rule posits that a central bank should set short-term interest rates based on an equation containing the expected rate of inflation, the value of the "neutral" short-term rate, the inflation gap, and the output gap. As applied to the US Federal Reserve, the equation becomes:

$$\text{Fed funds rate} = \text{expected inflation} + \text{neutral real fed funds rate} \\ + 0.5 * \text{inflation gap} + 0.5 * \text{output gap}$$

The inflation gap is defined as the difference between the Fed's preferred measure of inflation and its inflation target. The output gap is defined as the difference between actual and potential output. Using values of 2 percent for both the Fed's (implicit) inflation target and the neutral real short-term interest rate, the Taylor Rule does a credible job in tracking movements in short-term interest rates for much of the 1980s and 1990s. Table 6.1 shows, however, the large deviations between actual policy and policy predicted by the Taylor Rule.

The most striking element of these results is that actual policy deviated substantially from the Taylor Rule policy at exactly the times when the economy was showing persistent sluggishness and needed an additional stimulus—in the early 1990s and again in 2001–03.

Ninety-nine percent of the time an automatic pilot will fly an airliner as well as or maybe better than the pilot. But when some really exceptional situation arises, the pilot needs to be in control. This analogy illustrates how the Fed has helped the US economy. There have been several excep-

52. Blinder's comments can be found in Frankel and Orszag (2002).

Table 6.1 Actual monetary policy and the Taylor Rule, 1985–2003
(year-over-year percentage changes for output and CPI)

Year	Federal funds rate: Actual	Federal funds rate: Taylor Rule	Federal funds rate: Gap	Core CPI	Output gap
1985	8.1	7.1	1.0	4.4	–0.9
1986	6.8	6.7	0.1	4.1	–0.7
1987	6.7	6.7	–0.1	3.9	–0.3
1988	7.6	8.1	–0.5	4.4	0.9
1989	9.2	8.6	0.6	4.5	1.7
1990	8.1	8.8	–0.7	5.0	0.5
1991	5.7	7.1	–1.4	4.9	–2.5
1992	3.5	5.6	–2.0	3.7	–1.8
1993	3.0	5.1	–2.0	3.3	–1.8
1994	4.2	5.0	–0.8	2.8	–0.5
1995	5.9	5.2	0.6	3.0	–0.6
1996	5.3	5.0	0.3	2.7	0.0
1997	5.5	5.0	0.5	2.4	0.9
1998	5.4	5.3	0.0	2.3	1.8
1999	5.0	5.3	–0.3	2.1	2.4
2000	6.3	5.8	0.5	2.4	2.2
2001	3.9	4.5	–0.6	2.7	–1.1
2002	1.7	3.7	–2.1	2.3	–1.5
2003	1.0	1.9	–0.9	1.3	–2.1

CPI = consumer price index

Source: Goldman Sachs (2003).

tional circumstances in recent economic history when the Federal Reserve was able to respond in a way that helped the economy adjust to changes in economic variables that would not have been included in any likely Taylor Rule ex ante. The stock market crash of 1987, the Asian financial crisis, and the collapse of the Russian domestic debt bonds (GKOs) and long-term capital management fund (LTCM) are examples. The economic downturn that began in 2000 and intensified in 2001 is another example. The Federal Reserve realized the severity of the situation quickly even though unemployment remained very low. The federal funds rate was reduced to its lowest level in years, while the ECB, by contrast, was dragging its feet, using its inflation target as a justification for less aggressive rate moves. The ECB has maintained its refinancing rate well above the federal funds rate, despite the fact that the euro has risen against the dollar, and the euro economy looks weaker than both the US and the world economy. The ECB should have done more to improve economic performance in Europe in the past two or three years.

Macroeconomic Policy to Support Reform

European policymakers have been caught in a dilemma for many years about the extent to which macropolicies can be used to stimulate faster economic growth and the extent to which microreform is necessary for growth. Central bankers are usually supporters of microreform, pressing for greater labor-market flexibility and less government involvement in the private sector. When they are pressed to follow more expansionary policies, the bankers argue that such policies would only be inflationary, given that microreform has not yet been achieved. Thus, the lack of microreform becomes a reason, or an excuse, for the failure to act more aggressively to stimulate growth.

The policymakers charged with effecting microreform measures argue, in turn, that with economic conditions so weak, they have to protect existing firms in order to protect jobs. They cannot cut back on income support programs if unemployment is already high and jobs are scarce.

The result has been a stalemate in which neither side was willing to move aggressively on growth policies. That stalemate now shows some signs of being broken as reform programs move forward—as described elsewhere in this book. But the nature of the reforms is still affected by economic weakness. Budget pressures and the need for increased work incentives have played a role in reducing the level of support for retired workers and the unemployed. However, more needs to be done. The second phase of reforms that Europe must follow includes a shift to much greater economic flexibility and in order to achieve this goal, a short-term increase in structural unemployment may occur. That would be much easier to deal with if overall growth in Europe were stronger and aggregate demand were expanding more strongly.

Europe today has a strong currency and is not fighting an inflation battle. *It is an appropriate time to follow growth-promoting policies since there is emerging progress on microreform*. The ECB, while keeping its independence clear, should be willing to take a strong growth-promoting stand in its monetary policy and take an active role on center stage rather than waiting on the sidelines. Without help from the macropolicy side, the full potential of microreform in Europe will be much harder or even impossible to achieve.