How to rebuild the stability pact?

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In the fraught debate over the European Union's stability and growth pact, Gerhard Schroeder, the German chancellor, has proposed that the budget deficit limit of 3 per cent be lifted when governments do good things or face difficult economic conditions. Since these qualifications can only be written down in vague terms, he effectively suggests that the decision be left to the appreciation of the Council of Ministers. Put differently, the decision to put a country under the excessive deficit procedure will be based on political, not on economic criteria. In practice, the larger countries will be left off the hook when they misbehave while the smaller countries will be tied to the mast if only to prove that the pact is alive and well.

This is a recipe for disaster. Not only will it fail to enforce fiscal discipline but it will deepen the already growing rift between small and large countries. The small countries, which cannot afford to treat lightly their larger partners and the European Commission, have nearly all respected the stability pact. This serves them well, but what matters for the monetary union as a whole are the large flows of red ink that flow out of the larger countries. Frankly, these countries do not care much for what their smaller partners and the Commission think. The automatism built in the previous version of the pact was meant to treat all countries on the same footing. Its demise, the long foreseen consequence of poor economic design, should not be allowed to pit small against large countries.

Rebuilding the pact requires not just a better understanding of what fiscal discipline means, but also an imaginative political treatment to deal with the unique combination of a centralized monetary policy and decentralized fiscal policies. Chancellor Schroeder is right to note that, because fiscal policy is a matter of national sovereignty, foreign injunctions are bound to fail. The challenge is to find a way of respecting national sovereignty while recognising that unsustainable fiscal policies by one Eurozone member is a source of common concern for the other members, especially if the undisciplined country is large. The response to this challenge is not too to politicize and weaken the Stability Pact. What is required, instead, is that each country owns its commitments. Ownership means that commitments must be proposed by each member country and negotiated with the others. But the commitment must be hard, which requires that it be formally validated by both government and parliament to ensure delivery.

Regretfully, Chancellor Schroeder also goes wrong as he proposes to continue focusing on the budget deficit. This is strange as he recognizes that a large budget deficit need not signal a profligate and unsustainable fiscal policy. He is right to observe that there are good causes worth a deficit and that there may exist circumstances that call for sizeable deficits. But there is no way to anticipate what a good cause will be in the future, nor what circumstances will warrant flexibility. Today's Germany's valid reasons for flouting the 3 per cent rule are a poor guide to establish precise enough guidelines for the indefinite future. Is it impossible, then, to have any agreement that underpins fiscal discipline? The answer is to formally abandon the annual budget deficit criterion and focus instead on medium run targets for the public debts.

Indeed the only valid definition of fiscal sustainability is that the public debt - as a share of GDP - does not grow without bound. The revised Stability Pact should only concerns itself with the objective of stabilizing debts, hopefully bringing them down to more comfortable levels that may current ones. How would the pact work, then? Take the case of Germany whose public debt approaches 70 per cent of GDP. It may be argued that Germany could allow its debt to rise to 75 per cent over the next five years if it helps solving an important problem, much as a good case can be made for bringing the debt down to, say, 60 per cent. There is no simple, automatic answer. While no rule will ever deliver a good policy prescription, reasonable people can debate the pros and cons of each strategy and reach a reasonable conclusion. It is a decision to be made in the full light of a public debate between the German government and the Bundestag, ultimately settled by the German voters. Then the proposal should be submitted to the other Eurozone's partners. Once an agreement is reached, it should be formally ratified by the Bundestag.

The previous pact was so rigid that it could not work, but the kind of flexibility proposed by Chancellor Schroeder is clearly excessive. One of the pact's lethal characteristics was to focus on annual budget deficits; keeping this criterion up front will never work. Adopting medium run debt targets brings both good economic reasoning and the required degree of flexibility, without giving up on the essential, fiscal discipline. The pact's other lethal characteristic was to partly dispossess national governments and parliaments from their sovereign right to set fiscal policy. Replacing this top-down approach with a bottom-up approach must be part of any new political design.

The writer is a professor of economics at the Graduate Institute of International Studies in Geneva.