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contents

THE "ALMUNIA PLAN" FOR REFORMING THE STABILITY PACT: BETWEEN SCYLLA AND CHARYBDIS

Jürgen B. Donges
Professor of Economics. Head of the Economic Policy Institute at the University of Cologne. Former Chairman of the Committee of Economic Affairs Experts of Germany.

The Stability and Growth Pact (SGP) of the European Union, agreed by the Heads of State and Government of the EU-15 countries at the Amsterdam Summit in 1997, has lost credibility. It has been attacked on three flanks in recent years: the former President of the European Commission, Romano Prodi, publicly maligned it as being "stupid and imperfect"; the current governments of the three largest countries of the Euro Zone (Germany, France, Italy) are all unprepared to cut back their considerable budget deficits; and the former governments (Socialists) of the small countries (Greece, Portugal) manipulated their public accounts with various witty forms of creative accounting.

Now, **the proposal made by Commissioner Joaquín Almunia to reform the SGP,** and its subsequent approval by the European Commission on 3rd September 2004, **represent an attempt to legitimize** a posteriori **the infractions incurred by the above mentioned countries**. That is why the French and German Finance Ministers appeared to be so excited when they heard about the reform plan.

The arguments put forward to justify the reform of the SGP are, for all intents and purposes, absolutely weak. **It is not true that the ceiling established for the public deficit (3% of GDP) and outstanding debt (60% of GDP) prevent the implementation of an anti-cyclical policy.** When an economy enters into recession, State budgets, if previously balanced, contain an enormous margin (thousands of millions of euros) to support aggregate demand through the use of "automatic stabilizers", which have an effect on tax revenue (decreasing it) and expenditure (increasing it).

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It is not true that the SGP removes national governments and parliaments' central powers to shape the country's budget. On the contrary, each country is quite at liberty to decide, according to society preferences expressed through elections, whether it would like to have a large or small public sector, whether it would like to implement considerable or little expenditure on investment or stimulating consumption, whether it would like to apply high or low fiscal pressure, through direct or indirect taxes, and whether it would like to foster an extensive or minimal Welfare State. What the SGP demands is a form of financing that is solid and sustainable over time. **Neither is it true that budgetary consolidation holds back the growth of the economy and increases unemployment; modern macroeconomics draws exactly the opposite conclusions** and stresses the importance of the "confidence effect" on the markets, which is greater than any possible contractive effects that may be caused by reducing public expenditure. This hypothesis is confirmed by the experience of various European countries that have put their public accounts in order, such as Denmark (1983-1986), Ireland (1987-1989), Finland (1995-2000), Sweden (1996-1998) and Spain (1996-2003).

It is surprising that the German Socialist-Green Coalition Government should believe it is necessary to combat persistent weak domestic demand with greater spending and a larger budget, when this is precisely what the German Government has been doing in recent years (since 2002, breaching the SGP), without having been able to solve the growth crisis and the high levels of unemployment witnessed throughout the country. **Keynesian solutions adopted to stimulate demand are completely ineffective in an economy such as that of Germany,** plagued as it is by notorious rigidities and structural distortions in its labour market, tax system and social security system, among other areas of the economy.

Where Will the Plan Almunia Lead Us?

I do not believe that the **Almunia Plan will lead us to safety, since it leaves too many loose ends untied.** For example, it predicts that countries will enjoy a budget surplus during periods of economic expansion, but it extends the periods permitted for balancing the deficit without establishing any specific dates. Furthermore, **it proposes that the "special circumstances" of each country should be taken into account when it comes to evaluating their budgetary situation, although it is not very clear when it comes to defining the criteria** that would be added to those already provided for by the SGP (a serious economic recession or a natural disaster featuring grave financial repercussions for the country in question). And as if this were not enough, the Plan maintains the current sanctions mechanism in case of infraction, but it does not address the basic problem consisting of the fact that the guilty parties participate with a vote and a say in the decisions taken by ECOFIN regarding the measures that should be adopted. This means that convenient coalitions will prevent the European Commission from setting in motion those mechanisms for excessive deficit that are provided for in the SGP (which has occurred more than once in the past, and always with Germany in the thick of it).

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In this respect, **the Almunia Plan prepares the ground for a Pact "à la carte", one whose provisions each government will interpret as they see fit**. In specific cases of budgetary imbalance, the European Commission can make all the recommendations it likes, but the government in question will not pay any heed to them if it does not believe the moment has come to straighten out its fiscal policy. It is little use Commissioner Almunia promising that the maximum levels concerning the deficit and public debt will remain in force. Economic agents will not allow themselves to be deceived; they will incorporate risk premiums in long-term interest rates, which will have a negative effect on economic activity throughout all the countries located in the Euro Zone, including those that respect the SGP rules.

Macroeconomic stability is a sine qua non **condition for raising potential growth of output and job creation in the EU**, as promised by the European Council in the form of the "Lisbon Process". This implies a budgetary policy that is sustainable over time and compatible with a price stability policy entrusted to the European Central Bank.

"The Almunia Plan sends the wrong message to public opinion; namely that fiscal discipline shall be imposed, although the margins for discretional allowances shall be gradually widened. This is detrimental to the proper functioning of monetary union. Governments that have a sense of responsibility must reject the reform and revive the old spirit of the SGP"

The Almunia Plan sends the wrong message to public opinion; namely, that fiscal discipline shall be imposed in the Member Countries, although the margins for discretional allowances regarding the future application of the SGP shall be gradually widened. This is detrimental to the proper functioning of monetary union. Governments that have a sense of responsibility must reject the reform and revive the old spirit of the SGP, supporting budgetary policies that are subject to clear and transparent rules of behaviour, rules that are, consequently, credible to economic agents.

THE DANGEROUS REFORM OF THE STABILITY AND GROWTH PACT

Jaime García-Legaz
Trade Expert and State Economist.
Head of Economic Affairs and Public Policy at FAES

The reform of the Stability and Growth Pact proposed by the "Almunia Plan" constitutes a serious mistake. Authorizing larger public deficits or relaxing the budgetary stability measures established in the SGP will only lead to higher real interest rates throughout the Euro Zone and make the euro less attractive as an international reserve currency. The European Central Bank, the Bundesbank and the experts themselves at the European Commission have harshly criticized the proposed reform. The European Single Currency is the most significant step forward for citizens of the European Union in recent years and proposing reforms that present the grave possibility of weakening the euro is irresponsible. The stance adopted by the Head of the Spanish Government, which is to support the reform of the SGP in exchange for supposed favourable treatment in forthcoming Community financial negotiations, means renouncing the principle of budgetary stability and reveals the Spanish Prime Minister's weak negotiating position from the start.

The Stability and Growth Pact

The Stability and Growth Pact (SGP) was agreed in 1997 in order to ensure budgetary discipline among the Member States of the European Union, especially among those countries that fall within the "Euro Zone". It was wisely complemented by an independent European Central Bank with a clear mission: to prevent the risk that fiscal lack of discipline might foster the deadly disease that very often plagues currencies and monetary unions: inflation.

Budgetary discipline and price stability also facilitate a second goal: to maintain real interest rates at a low level, thus encouraging the formation of capital, economic growth and job creation.

"Budgetary discipline and price stability facilitate the maintenance of low real interest rates, thus encouraging the formation of capital, economic growth and job creation"

Contrary to what some observers have stated, the SPG is extremely flexible and can perfectly encompass the implementation of anti-cyclical budgetary policies. The SGP recognized the need for and approves of temporary budget deficits in order to handle the weakest periods of the economic cycle. It therefore supports the implementation of automatic stabilizers, featuring a budget deficit of up to 3% of GDP, a limit that can even be surpassed during recessions that are sufficiently harsh. The stabilizing power of the public deficit during the lowest points in the economic cycle resides precisely in the current rules established by the SGP, which make it credible to believe that an unbalanced budget will only be limited and temporary, as well as reversible.

What the **SGP sought to avoid was high and persistent budget deficits,** excessive deficits. **Budget deficits place pressure on the capital markets'**

capacity to capture savings, raising interest rates. If interest rates are high and persistent they raise expectations of higher taxes, among them, the inflationary tax. The markets react by raising interest rates again. This increase in the cost of financing is not only detrimental to those countries that suffer from excessive deficits, but also to those that respect the budgetary discipline established.

Thus, **as a general rule, the SGP establishes a budgetary balance that is close to equilibrium or a budget surplus, incorporating procedures to correct excessive deficits.** These procedures may culminate in financial sanctions that are imposed on fiscally irresponsible countries.

What Does the "Almunia Plan" Aim to Do?

The Almunia Plan seeks to acquiesce to countries that apply an irresponsible budgetary policy. It gives them a period to correct their excessive budget deficit (one year up until now) which presents no time-limits at all.

Furthermore, it aims to redraft the SGP with sufficient ambiguity to admit the arbitrary application of sanctions. It begins by redefining the concept of "special circumstances" when it comes to evaluating each country's budget situation. In this respect, it lists a series of macroeconomic variables as a reference-point, but carefully avoids any objective analysis of these variables: this represents a veritable carte blanche for arbitrary behaviour.

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The reform also fails to improve the existing sanctions mechanism in order to give it real credibility, which is essential if it is to be able to dissuade countries from building up excessive budget deficits. It continues to support a procedure in which a State that has acquired an excessive deficit participates in the decision as to whether it should receive sanctions or not. In short, **the Almunia Plan aims to legally consolidate the possibility of applying a policy of "unequal treatment", a policy that has, in fact, been implemented in recent years in the European Union.** If this "unequal treatment" is unacceptable in Community practices (as the Court of Luxembourg has ruled), it is even more unacceptable to attempt to modify Community Law in order to support those countries that flout the rules.

Another option that has been bandied about is the possibility of excluding certain public expenditure items when it comes to establishing what an excessive budget is. Expenditure on R+D policies, defence expenditure and even net transfers to the Community budget could all be excluded from the calculation of the public deficit figure for the purposes of the SGP. This option must be ruled out due to the fact that it is entirely arbitrary and lacks any kind of sound reasoning. Furthermore, it raises a question: Would those countries with net transfers to the

Community budget calculate these items symmetrically, as countries would that transfer net funds to the Community budget?

Dangers of the SGP Reform Proposal

The Almunia Plan will open the door for countries to acquire persistent and structural deficits in the European Union. The result will be an increase in interest rates in the long term. Independent central banks tend to take developments in long-term interest rates very much into account, because they offer valuable information as to expectations concerning inflation, expectations that are inflationary themselves. The European Central Bank, within a context of higher long-term interest rates, will end up raising short-term interest rates. The outcome will be a general increase in real interest rates, lower growth in capital formation and consumption, lower economic growth and lower job creation throughout the entire "Euro Zone".

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At the same time, a currency contaminated by higher inflationary expectations will suffer in its capacity as a reserve of value. **The euro will lose ground against the dollar as an international reserve currency and the European States will lose public income earned through seigniorage**.

For all these reasons, the European Central Bank, the Bundesbank and the experts themselves on the European Commission all have heaped harsh criticism on this Plan proposed by the Socialist Commissioner. **The ECB believes that the Plan "reduces the incentives to apply sensible budget policies, increases the risk of discretional behaviour and hinders the framework within which single monetary policy must be applied".** Experts at the European Commission's ECOFIN have stated that "in order to achieve greater fiscal flexibility within European Monetary Union, the obligation to fulfill the terms of the SGP must be strengthened, nor relaxed", to the extent that they have even recommended the Council of Ministers to reject the Commissioner's proposal.

How Can We Strengthen the Stability and Growth Pact?

The first thing we should point out is that **the SGP has worked well up until now. Europe has not returned to the budget deficit levels of the nineties**. This would not be the case if the SGP had not been in force.

If it were necessary to modify the SGP, any changes would **have to be contrary to those proposed by the Almunia Plan,** being aimed at **making the sanctions régime more credible**. It would be worth **establishing rules and criteria which are more automatic and less liable to be interpreted in an arbitrary manner.** It would also be a very good idea **to exclude the offending countries themselves from any decision regarding the application of the sanctions mechanism.** Furthermore, in view of the "Greek scandal", featuring the falsification of Greek public accounts in order to gain access to the euro, it would be necessary to **reinforce SGP mechanisms in order to prevent such practices**.

The main problem is that **the Almunia Plan is based on a combination of three fundamental errors**: **a) it trusts in the old Keynesian doctrine of fiscal deficit**, although erroneously interpreted and applied; **b) it follows traditional Socialist policies of increasing public expenditure** (especially expenditure on transfers to collective groups) based on obvious electoral goals; and **c) it represents an underhand rejection of the Lisbon Agenda on the part of a minority group of countries.** The Lisbon Agenda proposes budgetary stability, supply-side policies and structural reforms.

"The budget deficit is not an "instrument' of growth. Those countries that have failed to observe the Lisbon Strategy by rejecting structural reform and increasing public expenditure, have suffered economic stagnation and witnessed rising unemployment. Those countries that have applied the Lisbon recommendations and opted for reform and budgetary stability are the countries that have witnessed the strongest growth and created the most employment."

The conclusion is very clear: the budget deficit is not an "instrument" of growth. Those countries that have failed to observe the Lisbon Agenda by rejecting structural reform and increasing public expenditure, are the very countries that have suffered economic stagnation and witnessed rising unemployment. Those countries that have applied the Lisbon recommendations and opted for reform and budgetary stability are the countries that have witnessed the strongest growth and created the most employment. Whatever the case may be, **the budget deficit has become an indicator of failed economic policy,** based on the lack of willingness to apply structural reforms.

The Dubious Stance of the Spanish Government

The Head of the Spanish Government has stated that he would be prepared to support the reform of the SGP in exchange for supposed favourable treatment in future negotiations regarding Community financial policy. This stance is lamentable for two reasons: a) it represents an explicit renunciation of European budgetary stability and accepts the idea that principles and convictions can be exchanged for "a case full of money"; b) it represents the Government's weak negotiating position from the beginning, a dreadful negotiating strategy. This should not surprise us, because the same thing happened when it came to negotiating the European Constitution.

Conclusions

The reform of the Stability and Growth Pact proposed by the **Almunia Plan represents a serious threat to the credibility and stability of the euro in the long term.** Relaxing the budgetary stabilization measures provided for in the Stability and Growth Pact and increasing the arbitrary application of its rules still further will only lead to higher real interest rates, lower economic growth, lower job creation and a weaker euro that is less attractive as a reserve currency.

"The Almunia Plan will fuel the doubts of the Euro-sceptics and make it less likely that the Member States that have voluntarily remained outside the euro (The United Kingdom, Sweden and Denmark) will join the single currency"

The European Single Currency is the most significant real and practical step forward for the citizens of the European Union in recent decades (the most important "specific achievement", in the words of Robert Schuman) and it has taken forty years to make it a reality. And if it is still a healthy reality today it is precisely because it has been supported from the start by the guarantees offered by the SGP. **European Monetary Union is still young and proposing reforms that only weaken the euro is irresponsible.**

As if this were not enough, the Almunia Plan will simply fuel the doubts of the Euro-sceptics and make it less likely that the Member States that have voluntarily remained outside the euro (The United Kingdom, Sweden and Denmark) will join the single currency.
