Franz-Christoph Zeitler: The Stability and Growth Pact

Speech by Professor Franz-Christoph Zeitler, Member of the Executive Board of the Deutsche Bundesbank, at the Forum for discussion of the Friends of Europe, the Hanns Seidel Foundation and the Konrad Adenauer Foundation, Brussels, 16 February 2004.

*   *   *

Ladies and gentlemen

I extend my thanks to the organisers - the Friends of Europe, the Hanns Seidel Foundation and the Konrad Adenauer Foundation - for cordially inviting me to speak at this forum. I thank you for drawing attention to one of the fundamental elements of, and pillars of confidence in, monetary union: the Stability and Growth Pact!

I

If we look more closely at the short and snappy term "Pact" and analyse it from a legal standpoint, we see that it is an umbrella term that covers three legal instruments.

– A Council Regulation on speeding up and clarifying the implementation of the excessive deficit procedure (Regulation (EC) No 1467/97 of 7 July 1997).

– A Council Regulation on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies (Regulation (EC) No 1466/97).

– A European Council Resolution taken at the Amsterdam summit on 17 June 1997.

Naturally, the "mother of all rules" remains the Treaty on European Union; Article 104 (1) states clearly that "Member States shall avoid excessive government deficits."

Article 104 of the Treaty also regulates the monitoring and infringement procedure. What the above Regulations and the Council Decision do is merely specify and expedite the procedure. I think that one thing deserves to be emphasised.

Contrary to contemporary popular usage, the "Pact" is NOT just an intergovernmental agreement, but rather an instrument to apply and implement primary and secondary European legislation.

II

Maybe this relatively complicated legal construction, which the general public is not widely aware of, is why the Stability and Growth Pact is wittingly or unwittingly described as "rigid", "too legalistic" and "too economically inflexible". This is also why it is our job, as central bankers, to communicate the *economic and fiscal policy aims* of the Pact. The Stability and Growth Pact does not exist for its own sake, nor is it the "hobby horse" of some central bankers; rather, it is a requirement for the *long-term effectiveness of monetary union.*

I would like to explain this by emphasising *three factors* at work here.

1. The specific approach underlying European monetary union, the well-known "Maastricht approach", is based on a single, independent monetary policy while fiscal policy remains under national responsibility, albeit coordinated and rule-based. This sets the euro area apart from other single currency areas. A rule-based fiscal policy is necessary to avoid *conflicts* between **monetary policy and fiscal policy**. Such conflicts can result from the fact that excessive deficits and the resultant excessive debt make government budgets increasingly **sensitive to interest rates**. In cases of excessive debt, fiscal policymakers are tempted to put pressure on monetary policymakers to solve their problems at the expense of long-term **price stability**.

   In addition, the danger of such a conflict is even greater if public debt is increasingly financed using short-term debt.

When I say that compliance with the Stability and Growth Pact *avoids conflicts* that could undermine the functioning and the internal cohesiveness of monetary union, there are other important aspects to consider.

Prior to monetary union, every country's fiscal policy was judged by the markets, and if it was inadequate, adverse market reactions in terms of exchange rates and interest rates were to be expected. However, *in monetary union* a potential "market risk premium" is spread across the whole euro area - with the exception of perceptible but relatively narrow spreads in long-term bonds. This means the Pact is a type of "insurance" against the age-old human temptation to be a "free rider" and to make others pay for one's own actions.

2. Another equally important reason for the Pact is an **economic reason**. Balanced budgets, or at least low deficits and acceptable levels of debt, are an important *condition* for **growth and prosperity**. Excessive deficits are accompanied by high government shares in GDP - in Germany, the spending-to-GDP ratio in 2003 was 49% (up from 39% in 1970). What a high spending-to-GDP ratio and the resultant high tax and social security ratio do, however, is reduce general efficiency, promote the relocation of investment and jobs, cause adverse changes in the behaviour of economic agents (eg an increase in the "shadow economy") as well as strain important resources of society, resulting in moves to avoid taxes and levies as well as to obtain transfers and subsidies, a practice also termed "rent-seeking".

Conversely, balanced budgets or at least low deficits and low levels of debt allow for lower taxes and facilitate private investment and also government investment. Low interest rates give the public sector more scope for investment to improve the public infrastructure.

A comparison of growth rates in Europe confirms that countries with lower deficits have faster growth rates, whereas countries like Germany, which have repeatedly exceeded the Pact's 3% deficit limit (2002: 3.5%, 2003: 4%, also expected to be well over 3% in 2004), have to battle persistent stagnation and unemployment.

The Pact is therefore also a sort of insurance against the typical risks to growth and prosperity in modern societies with a high spending-to-GDP ratio. It is insurance against the temptation to use lavish government benefits to buy votes in the present and pass the bill on to future generations which are not yet eligible to vote.

"Sustainability" is not just an ecological principle; it is also a principle of fiscal responsibility. It is particularly important against the backdrop of the demographic strains and the attendant hidden government debt caused by an ageing society.

We need to remember that "economy", in the sense of its Greek root word *oikonomiā*, simply translates to "management of a household or family", ie rule-based behaviour.

3. Thirdly, the obligation to keep government deficits below the **3% limit is by no means rigid**. Weighing up all the pros and cons, it is an appropriate and sound course of action.

- The Pact strives to achieve balanced budgets throughout the entire *economic cycle*. Budgetary positions close to balance or in surplus in good years allow automatic stabilisers (cyclically-related lower tax revenue, higher costs of unemployment) in economically bad years.
- Practical experience (eg abeyance if a member state has promised to take measures which have not yet been implemented) has shown that the monitoring and infringement procedure is quite time-consuming. In practice, the process from "early warning" to "recommendations" to "defining a deadline for adaptation" to the imposition of an interest-free loan to a fine may last two to three years - giving governments sufficient time to take flexible adjustment measures.
- Finally, what is often forgotten is that the 3%-limit was chosen for Maastricht against the background of an expected nominal growth rate of 5% and a real trend growth rate of 3% (3% nominal deficit in terms of 5% growth result in a trend debt level of 60%). Today we know that these assumptions regarding potential growth were very optimistic and that actual growth has been much lower. The 3%-limit is therefore relatively generous.

III

The Ecofin council's decision on 25 November 2003 not to act further on the basis of European Commission recommendations regarding France and Germany subjected the *Stability and Growth Pact* to a *crisis* and an *acid test*. Prior to the decision, some said that if the procedure was not pursued properly in accordance with Article 104 (8) and (9) of the Treaty, the Pact was effectively "dead". The press was rife with black humour - "obituaries" of the Pact were published. I do not share this view. A look at everyday life shows us that violating a rule or norm does not automatically invalidate or "kill" it. However, we must do all that we can to implement the Pact, to reactivate it and thus to *restore* the weakened public *confidence* in the "Maastricht rules".

The evident confusion and obvious differences of opinions about the fundamental questions regarding the workings of the Stability Pact as defined by the Treaty and the Council Regulations are cause for concern. Does the Council of Finance Ministers have leeway for continuing the procedure if it *materially* shares the Commission's view that a member state has not sufficiently complied with its obligations? Can the Council adopt a new *recommendation* (Article 104 (7)) even if a member state did not sufficiently comply with earlier recommendations, causing and the *Commission* therefor has submitted another proposal (cf Article 104 (13))?

Finally, does the official declaration of the Heads of State or Government made in Amsterdam in July 1997, according to which the Council of Finance Ministers

> "is invited always to impose sanctions if a participating Member State fails to take the necessary steps to bring the excessive deficit situation to an end as recommended by the Council",

have only political significance, or does this not also imply that they have committed themselves to comply with the terms of the Stability and Growth Pact? Article 31 (3) of the Vienna Convention on the Law of Treaties expressly recognises the possibility of such "subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions". It has therefore become such a fundamental question of *credibility* that the Commission, in its role as the "guardian of the EU treaties", filed an objection to the Ecofin council's decision of 25 November with the European Court of Justice. It is also necessary to avoid "contagion of other members" other member states or acceding countries.

Until the European Court of Justice has decided on the issue, I certainly believe it is *not necessary* to discuss *changes* to the Pact. There may indeed be some well-meaning and reasonable suggestions out there with the intent of improving the Pact's effectiveness, such as the idea of "giving the Pact more muscle" in the event that a member state fails to reduce structural deficits in good years and thereby robs itself of the discretionary scope to stay under the 3%-limit in not-so-good years.

Despite all the proposals, it must be borne in mind that loosening the rules of the Pact might open up a Pandora's box, and a new legal framework could have potential damaging effects on growth and conflict avoidance in monetary union. The aim must always be to achieve effective, operable and transparent procedures. As the ancient Romans told us, "Quidquid agis ... respice finem".