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EU Economic Governance

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EU Economic Governance

NOTE

Abstract

On September 29, 2010, the European Commission announced a set of legislative proposals to improve economic governance in the European Union. The package is wide-ranging and consists of six proposals, four of which deal with fiscal questions and two with broader macroeconomic balance issues. While shortcomings remain, the proposed measures, if implemented, will improve the management of economic policy in the European Union. In turn, better economic policy will promote the smooth functioning of the European economy.

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1. Introduction[1]

On September 29, 2010, the European Commission announced a set of legislative proposals to improve economic governance in the European Union. The package is wide-ranging and consists of six proposals, four of which deal with fiscal questions and two with broader macroeconomic balance issues. While shortcomings remain, the proposed measures, if implemented, will improve the management of economic policy in the European Union. In turn, better economic policy will promote the smooth functioning of the European economy.

The thrust of the proposals is to help governments manage the economy better and there is little emphasis on sanctions. This balance is appropriate and will raise the likelihood that member states will take ownership of, and comply with, the rules. The historical record indicates that, when push comes to shove, governments are unwilling to impose sanctions on their peers. It is therefore appropriate to focus on improving policy by adopting realistic and sensible rules, and to strengthen the relevant institutional arrangements.

Nevertheless, fiscal policy involves the redistribution of income and wealth and is therefore intensely political, which induces a deficit bias as has been demonstrated all too clearly in Europe in recent years. To mitigate this tendency, it is important that effective sanctions are available if a member country does not comply with the rules. In this regard, the proposals envisage sanction mechanisms for both the Stability and Growth Pact (SGP) and for the Excessive Imbalance Procedure. The rules provide for small and quasi-automatic sanctions – that is, sanctions are automatic unless a majority of member states decide not to adopt them. Overall, these arrangements appear appropriate.

Below I review the main proposals and point out some shortcomings that may warrant reflection. I first discuss the measures to strengthen fiscal policy, before turning to the identification of imbalances. Policy conclusions are provided in bullet points.

2. Strengthening fiscal policy

The intention by the Commission's proposals is to enhance the SGP by introducing a medium-term budgetary objective, by putting more emphasis on the level of public debt, by making the sanction regime more effective and by improving fiscal institutions in the member countries.[2]

2.1 The debt criterion

The SGP, as initially envisaged, proscribed budget deficits greater than 3% of GDP and a public debt to GDP ratio greater that 60% "*unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.*"[3] In practice, however, the debt criterion was never enforced since so many member states exceeded it and the terms "*sufficiently diminishing*" and "*satisfactory pace*" were not defined. The proposals of the Commission seek to remedy this shortcoming. Since the Greek public debt crisis was caused by the government's history of disregarding the SGP, this proposal is of crucial importance.

In addition to the deficit criterion, the new rules require those member states whose debt-to-GDP ratio exceeds 60% to reduce that ratio by 1/20 of that excess that year. Thus, a member state with a debt of 80% will have to reduce that ratio by (80% - 60%)/20 = 1% per year. That is a realistic undertaking. However, the OECD Economic Outlook of October

[1] I am grateful to Anamaria Piloiu for very able research assistance.
[2] See also the comments by Manasse (2010) and Wyplosz (2010).
[3] Article 126 of the Treaty (ex Article 104 TEC) – The Excessive Deficit Procedure http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:12008E126:EN:NOT

2010 forecasts a debt-to-GDP ratio for Greece in 2011 of about 140%, implying a need to reduce that stock by 4% per year.

This could be problematic. To see this, note that the change in debt-to-GDP ratio, ΔD, equals the stock of debt, D, times the difference between the real interest rate and the real growth rate of the economy, r-g, minus the primary budget surplus, S: $\Delta D = (r-g)*D - S$. Using the requirement that $\Delta D = -(D-60)/20$, we can then calculate the primary budget surplus for different hypothetical debt levels, real interest rates and growth rates of real GDP.

Figure 1 shows the required primary surplus, assuming a debt-to-GDP ratio of between 60% and 150% of GDP. The required surplus depends on the difference between the real interest rate and the growth rate of real GDP; the Figure contains plots assuming that this difference is 3%, 5% or 7%.

To use this figure we must make an assumption about how large the wedge between the real interest rate and real GDP growth will be in the coming years. Table 1 shows some simple back-of-the-envelope calculations using pre-crisis data from the data appendix to the OECD's Economic Outlook. The average long real interest rate in the euro area in the period 1999-2005 was 2.1% and the average growth rate was 3.0%, implying that wedge was negative. In such a situation, assuming that there are no new deficits, debt automatically shrinks. It is unlikely that this situation will repeat itself, especially for the countries with the largest debt problems. This is so for two reasons.

First, one reason for the low average real interest was that inflation in Greece, Ireland and Spain was much above the (unweighted) average inflation rate among the EMU members. Since all three countries need to restore competitiveness, their inflation rates are likely to be quite a bit below 2% per annum (since the ECB's inflation objective is "below but close to 2 %"), say 1%.

Second, before the crisis euro area government borrowed at nominal interest rates broadly similar to those of other euro area countries since financial market participants either did not expect a fiscal crisis to happen or, more likely, (correctly) expected crisis countries to be bailed out. Since default risk is now an issue, governments with excessive public debts pay large premiums. While the Greek long interest rates are some 800 basis points above German rates, this must be a temporary phenomenon since the Greek debt is too large for the government to be able to service it at the implied real interest rate. But it seems plausible that Greece may pay a 300 basis points premium over German rates in the next years.

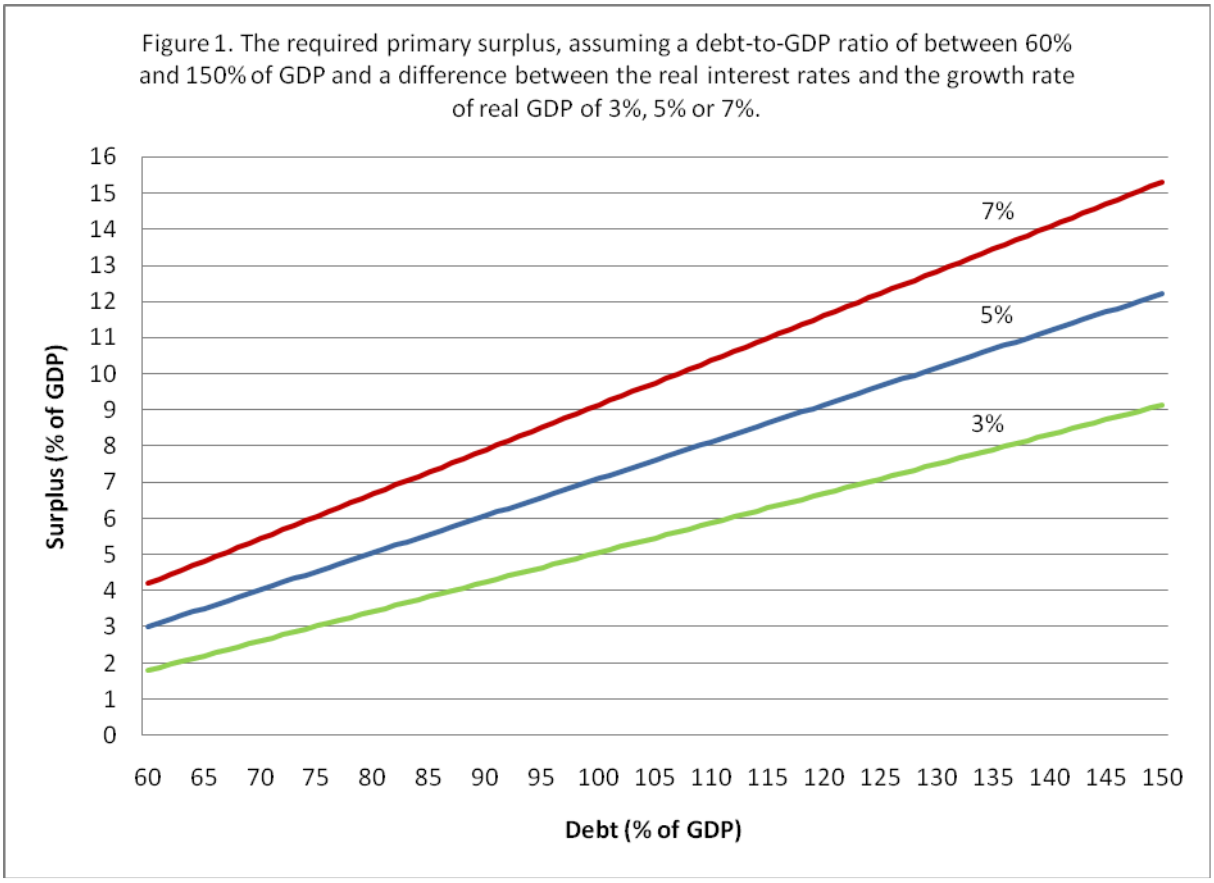

Table 1. Average growth rates and interest rates for the period 1999-2005

Country	Average long term interest rate (1999 - 2005)	Average CPI inflation (1999-2005)	Average real interest rate	Average real growth rate (1999-2005)	Average real interest rate - Average real growth rate
Austria	4.57	1.69	2.88	2.22	0.66
Belgium	4.54	1.96	2.59	2.18	0.41
Finland	4.55	1.59	2.95	3.22	-0.26
France	4.49	1.79	2.70	2.20	0.50
Germany	4.40	1.43	2.97	1.16	1.80
Greece	4.99	3.22	1.77	4.05	-2.28
Ireland	4.54	3.56	0.98	6.78	-5.80
Italy	4.66	2.35	2.31	1.39	0.92
Luxembourg	4.04	2.68	1.36	4.98	-3.62
Netherlands	4.50	2.64	1.86	2.18	-0.32
Portugal	4.61	2.99	1.62	1.74	-0.12
Spain	4.56	3.10	1.47	3.73	-2.26
Average	4.54	2.42	2.12	2.99	-0.86
Standard Deviation	0.21	0.72	0.70	1.65	2.20

Source: OECD Economic Outlook No. 87, Annex Tables

The German long real interest rates averaged about 3% before the crisis. If Greece pays a 300 basis point risk premium and Greek inflation averages 1% less than inflation In Germany (implying that the real interest rate in Greece will be an additional percentage point higher than in Germany), it seems plausible that Greek will pay a real interest rate of perhaps 7%.

Third, real GDP growth in Greece averaged about 4% per annum before the crisis; because of the financial crisis achieving half that might be a more realistic goal. If so, Greece may face a situation in which the real interest rate exceeds real GDP growth by 5%. As Figure 1 shows, Greece may well have to run a primary surplus of 10% of GDP. That does not seem to be easily achievable.

That suggests two policy conclusions:

- The requirement that countries reduce their debt-to-GDP ratio by one-twentieth of the excess of the debt-to-GDP ratio over 60% implies that some countries must run implausibly large fiscal surpluses.
- It seems desirable to consider a much simpler system that does not require such large debt reductions by Greece. For instance, member states that have debt-to-GDP ratio above 60% but below 80% should reduce the stock of debt by 0.5% per year; those that have debt of between 80% and 100% should reduce the debt by 1.5% per year, and those that have debts in excess of 100% should reduce debt by 2.5% per year.

I next review some particular aspects of the proposals that fruitfully could be clarified.

2.1.1 "Medium-term budgetary objectives"

The notion of "medium-term budgetary objectives" (MTO) appears prominently in the proposals but is confusing. First, how it is defined? Does it pertain to levels of spending, size of budget deficits or stocks of debt? Second, how is it related to the rules for debts and deficits? Since these are much clearer than before and are directly operational, it seems odd to have further rules that may be superfluous or, worse, risk contradicting the reinforced rules of the SGP. Thus, if a member country is in compliance with the deficit and debt rules, what role does the MTO then play? And if they are not in compliance, does not the debt criterion provide "enough" of a constraint?

- The notion of medium-term budgetary objectives and their overall role and objectives needs to be clarified or the references to them should be removed.

2.1.2 Procyclicality

There is a risk that these arrangements will introduce procyclicality in fiscal policy since they will require countries to tighten fiscal policy if the economy slows and the surplus targets cannot easily be met. Of course, this problem is mitigated by the fact that the rule pertains to the average change in the debt-to-GDP ratio over a three-year period. However, business cycle contractions can last more than three years.

Two possible solutions to this problem are readily apparent. First, the three-year period can be extended to five years. That, however, reduces the disciplining element. Second, a cyclical adjustment can be introduced. If so, the rule would be used to compute a minimum cyclically adjusted primary surplus. One attractive aspect of that solution is that it would automatically require member states to use the extra tax revenue collected during an upswing to reduce the public debt.

- Measures to reduce the procyclical consequences of the proposal should be considered.

2.1.3 Transition arrangements

The analysis above assumes that the economy is at steady-state. In the near future, however, real economic growth is likely to be much below the steady state level. For instance, the OECD predicts real GDP to fall in 2010 in Greece, Ireland and Spain, and it to fall further in Greece in 2011, and to grow below 1% in Portugal and Spain. In turn, implies that debt will increase relatively fast (or contract relatively slowly) in the coming years.

This effect is exacerbated by the fact that markets demand large risk premiums for holding the debt of the member states with the largest debt-to-GDP ratios. Thus, the wedge between the real interest cost of the public debt and real GDP growth is likely to be substantial for these member states in the coming years.

This is a problem because the proposed new debt-to-GDP rule applies to the average over a three-year period. Thus, if little progress is made during the first two years, all the more progress must be made in the third year. Consider for instance a member state with a debt-to-GDP ratio of 100%, implying that it should contract the stock of debt by 2% per year. Suppose instead that debt grows by 2% in each the first two years. If so, the member state must reduce the debt to GDP ratio by a massive 10% in the third year. That would be very difficult.

- The implementation of the debt-reduction rules must either be delayed for a few years or some interim rules need to be considered.

2.2 The Maturity structure of the debt and "bunching"

The importance of the maturity structure of the public debt is not mentioned in the Commission's proposals. This seems unfortunate. First, since the term structure of interest rates in typically upward sloping, governments have an incentive to borrow short term since this is typically less costly. However, doing so raises the need for a frequent roll over of the debt, which increases the risk of a roll-over crisis.

Furthermore, one reason why the term structure may be upward sloping is that investors are concerned about the likelihood of a fiscal crisis and therefore shy away from holding long-term debt. Overall, a relatively short maturity structure of the public debt is thus an indicator of roll-over risk.

A further reason why the maturity structure matters is that even if the average maturity of the debt is adequate, a large number of bonds may mature in a short span of time. Such "bunching" raises the risk that a roll-over crisis will occur, in particular if it happens around the time of another event of potential importance for fiscal policy, such as an election.

- Some consideration should be given to the potential need for rules, or a definition of "best practice", with regarding the maturity structure of the debt.

2.3 National Fiscal Frameworks

The Commission's proposal includes measures intended to strengthen national fiscal frameworks. This is highly desirable. The last two decades of reforms of central banks across the world suggest that a strengthening of institutional arrangements, in particular greater independence from political authorities, have played a crucial role in improving the management of monetary policy. It seems likely that similar gains can be achieved in the area of fiscal policy.

While the proposals are thus to be welcomed, they lack specificity. For instance, it is unclear what is meant by "realistic macroeconomic projections" or "comprehensive and transparent multi-annual budgetary objectives," to give but two examples. Of course, it is difficult to define these terms. But this raises the risk that they might be disregarded, by design or accident.

Furthermore, while the proposals set out minimum requirements to be followed by member states, that level of ambition runs the risk of being too modest. To avoid an outcome in which a lack of specificity leads to too little action, thought should be given to adopting the following measures:

- The Commission should define "best practice" in the area of fiscal frameworks.
- Member states should commit to adopting this "best practice" standard. Since some practices, such as the establishment of independent fiscal councils, will take time, they must be given a period, say three years, to do so.
- The Commission should carry out regular audits to ensure that the "best practice" standard is adhered to and to update its definition thereof in light of country practices.

3. Macroeconomic Imbalances

The Commission's proposals contain novel elements that are intended to help prevent and correct macroeconomic imbalances. The idea is to expand the EU's economic surveillance framework to include regular evaluations of imbalances, and the risks they may pose, using a broad set of economic indicators. Any identified imbalances would trigger further review, perhaps leading to policy recommendations and, in the extreme, the initiation of an Excessive Imbalance Procedure.

It is easy think of weaknesses with this proposal. For instance, there is little agreement about what constitutes an imbalance or how it can be identified.[4] Any determination by the Commission that an imbalance is present may therefore lack legitimacy and may run the risk of being challenged or disregarded. Moreover, for many imbalances it may be difficult to define an appropriate policy response.[5] In light of these difficulties, there is naturally some skepticism about this component of the proposals.

But no progress will be achieved in this area unless an attempt is made to address imbalances and unless potential policy responses are contemplated. And there are good reasons to believe that at least some imbalances may be harmful. For instance, current account deficits are associated with property booms.[6] Such deficits can be caused either by a range of domestic factors, including fiscal deficits, or by capital inflows caused by external developments. Since the appropriate policy responses depend on the reasons for the imbalances, investigating their sources is important, although admittedly difficult.

In thinking about such imbalances, it should be recalled that policy spill-overs can be large and policies that are desirable for an individual economy can have detrimental effects in surrounding member states. For instance, domestic developments can trigger capital outflows and in this way contribute to housing booms and raise financial stability risks abroad. It is therefore appropriate to consider both surplus and deficit countries. Moreover, "evenhandedness" in dealing with policy makers in deficit and surplus countries will enhance the credibility of the proposals.

[4] See Tabellini (2010).
[5] See Giavazzi and Spaventa (2010).
[6] See Bernanke (2010) or Reinhard and Rogoff (2009).

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