Prof. Dr. Joachim Scheide
The Kiel Institute for World Economics

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For the Round Table on the Stability and Growth Pact

The current discussion about economic policies in Europe is an indication that the tensions in the monetary union have increased. Also, the consensus about economic policy may fall apart. Both things are not good news for the future of the European Union.

Why do we have the discussion on the Stability Pact now and not 4 or 5 years ago when it became effective? And why have not all the 15 governments and the Commission been criticized all along for having targets and rules for fiscal policy, which are, for example, described in the annual BEPG?

The reason is obvious: Today, a few countries have problems to meet the commitments they have made over and over again in recent years. This is the first test of the Pact, and it shows that this coordination effort at the European level has failed. What is the message that the accession countries get from all this? They are told that they have to bring their house in order first before they can enter the EU or later the monetary union, and reducing their budget deficits is one of the requirements. Now they learn that not even the insiders care about this!

Why do we have these problems with the budget in four countries? Is it because the SGP is too rigid, in order not to use the “S” word? Or is it that those countries simply did not want to meet the target of a balanced budget in the first place? Or, to put it more politely, did they just make wrong assumptions or other policy mistakes?

I think that we do not have to discuss the case for a balanced budget. This is extensively described in the policy framework of the EU and also in the literature. Not everybody may agree with the work of Friedman, Feldstein, Lucas or others, but the case is sound. Also, the issue of automatic stabilizers does not need discussion as there is a broad consensus that they should be allowed to work, although that also depends on the model you have in mind. (For example, in models of the new neoclassical synthesis the automatic stabilizers may not be optimal at all.) And we should, of course, only talk about <u>structural balances</u> which has become common sense at the European level.

The fact is that 11 out of the 15 Member States have already balanced their budgets this year, in some cases even earlier, and several countries have surpluses. So balancing the budget is possible and not just a matter of good luck. By the way, these eleven countries have performed well in recent years and are not suffering from excessively rigid fiscal policies. A few years ago, they were, on average, certainly not in a much better position than the other four countries which have not met the target. In many cases, the budget deficits were much higher than the deficit in, say, Germany so their objective was often more ambitious. And one cannot say either that they enjoyed better macroeconomic conditions: They had more or less the same external environment and practically the same monetary policy, with the important exception of the UK, of course. So while eleven countries have already reached the target, four countries claim that they need <u>at least nine years</u> to balance their budgets. In the case of Germany that started with a deficit of 2 percent in 1997 this claim is – excuse me – ridiculous. There must be other reasons for not meeting the target.

Was it the Pact itself? Has it been so rigid that there are severe problems now? Since I do not want to tell other countries what they should do, let me take the example of Germany: Is the current problem of the German economy in any way related to the Pact? Did Germany pursue a fiscal policy which was too restrictive because the government wanted to meet the target? And is that the reason why the German economy is now in such a bad shape?

Far from it! If we look at the current estimates of structural deficits – published, for example, by the European Commission – Germany's fiscal policy has been more expansionary in recent years than in the average of the EU. In 2002, the structural deficit is higher than last year, and it is higher than in 1997. The fact that the deficit was not reduced cannot be blamed on the cyclical downturn. Or, as the Commission put it in its recent forecast: There are larger downward revisions concerning economic growth for Member States with budget problems! (page 21). I am not saying that this is an example of non-Keynesian effects of fiscal policy because that case is certainly more complicated and needs more careful analysis. But it can certainly not be said that the Pact is responsible for a too tight fiscal policy and that the Pact is the cause of the problems that we have now.

I would agree that a balanced budget is not the only or even the best indicator for a good fiscal policy. But the SGP is not the only rule for fiscal policy in the EU. The Pact has to be seen in the context of the BEPG where the policy of fiscal consolidation is described: It includes a reduction of the share of government – where necessary – and also a reduction of the tax burden; in addition, it calls for a shift of government expenditures away from consumption towards investment. This policy is certainly a prescription for higher growth, and this is what the Guidelines are about. Most of the measures currently taken by the German government, for example, are the opposite of this policy recommendation.

What else should we expect from fiscal policy? The Guidelines are also quite clear with regard to stabilization policies. There is no role for fiscal policy in this context: “Given the numerous drawbacks of fiscal fine-tuning to stabilize output, the norm for budgetary behaviour should be to let the automatic stabilisers operate freely … “.

This view is close to the consensus in macroeconomics today on the ineffectiveness of fiscal policy. And I think much of the discussion about the supposed inflexibility of the SGP arises simply because many people expect too much of fiscal policy, for example, that fiscal policy can and should stabilize the national output gap. If we really believe that raising government expenditures is a good thing and that it raises output, we should all be for it. But, as experience shows, this is not always the case. For many government expenditures the multiplier is not positive and large – but negative. The reasons are given in the macro models that many of us use today, and there is ample empirical evidence supporting this theory.

To conclude: The SGP is, as the ECB put it, fundamental to the monetary union and to the member states. It has to remain intact. The recent proposal of the Commission is a practical procedure to return to sound fiscal policies in the problem countries.

To come back to my starting point about the consensus in Europe: We would not have the monetary union today without the SGP. And we would not have the monetary union without the clear mandate of the ECB as it is now. The problems that some European economies may have today have nothing to do with any of these two pillars of European policy. Nevertheless, both pillars have been criticized recently. If the consensus is given up, the monetary union itself is in trouble. Whether that is good or bad news is for everybody to decide.