IMK Report
No. 51 | July 2010

Reforming the European Stability and Growth Pact: Public Debt is Not the Only Factor, Private Debt Counts as Well

Gustav A. Horn, Torsten Niechoj, Silke Tober,
Till van Treeck, Achim Truger

The global financial crisis has resulted in a massive increase of public debt, and the European Stability and Growth Pact (SGP) has been unable to prevent this trend. Presently, most European governments respond by introducing tough budget consolidation programmes. The current crisis made blatantly obvious that the institutional framework of the European Monetary Union (EMU) is inadequate. This fact has initiated a scientific debate about the SGP. Most reform proposals concentrate on public debt, thus intensifying the pact's traditional one-sided focus on public debt. But this strategy could prove to be fatal, for economic developments in the short-run as well as for mid-term growth: The economic recovery in the European countries would be curbed, without tackling the actual problems of the euro area. Not only public debt is a continual threat to the stability of the EMU, private debt counts as well. Thus the euro area's fundamental problems will not be solved without a reorganisation of the SGP. After reviewing major reform proposals, the IMK will present its own concept for an innovative SGP reform strategy. Our main focus will be on current account balances, because they are able to reveal perilous trends both in the public as well as in the private sector.

Established on May 9th 2010 in the midst of the financial crisis, the European Union's 750 billion euro rescue package at least secured government borrowing in the euro area, preventing the threatening collapse of the monetary union. But this fund also demonstrates the complete failure of the SGP. This pact has not prevented several member governments from finding themselves as viewed as being on the verge of bankruptcy. Reason enough for a debate about various reform proposals. The European Commission itself, as well as its specially implemented Task Force, have submitted proposals, along with the European Central Bank (ECB) and several economists. The majority of these proposals concentrate on the stricter monitoring of the SGP's deficit criteria, and on tougher sanctions in case of violations. These criteria require the national public budget deficits not to exceed 3 % of the GDP, and the public debt-to-GDP ratio not to be larger than 60 %.

As far as the actual economic problems of the euro area are concerned, this narrow focus on public debt misses the point entirely. The examples of Spain and Ireland illustrate this clearly: Both countries have never violated the 3 % deficit criterion between 1999 and 2007, their debt-to-GDP ratio was – in Spain after 2000 – below the 60 percent margin and had decreased over time notably. Nevertheless, these two countries now find themselves in the "PIGS" group (Portugal, Ireland, Greece, Spain), a disrespectful acronym for the four European member states whose credit ratings were suddenly questioned on the financial markets.

Their national deficits had increased sharply because both governments had to react to bursting credit bubbles and demand shortfalls due to the financial crisis. In fact, private debt was thus transformed into public debt; the public debt-to-GDP ratio exploded accordingly. It stands to reason that the combined debt of both public and private sector would be a far more sensitive indicator for impeding national debt overload than the budget deficit alone. The joint financial position of both sectors is shown in the current account balance and in the foreign debt-to-GDP ratio.

In this report, we will illustrate how an improved SGP could meet economic imbalances between member states. Furthermore, we will explain the role of fiscal policy within the framework of this modified pact. Adherence to the faulty design of the failed SGP and its rules would entail high risks for the entire euro area: In the short term, the European Union would face an economic downturn and rising unemployment rates; in the long term, the EMU could even break apart, if the economic imbalances between the member states are not resolved. To prevent the latter scenario, fiscal policies have to be coordinated: The inevitable consolidation in countries with current account deficits have to be complemented by more expansionary policies in countries with current account surpluses. In a coordinated effort, expenditure paths for countries with a significant current account deficit should be developed and would decrease their high debt-to-GDP ratio far more effectively than adhering to fiscal deficit or debt criteria.

Reforms are inevitable

In order to sustain aggregate demand, most countries of the euro area have introduced economic stimulus packages in 2009 and 2010, after the Europe-wide economic downturn started. If governments had not accepted higher budget deficits to render these packages possible, an even lower aggregate production would have resulted, as the private sector suddenly desired to increase its saving and to withheld investments. Moreover, extensive financial grants were provided for the banking sector.

Nevertheless, speculation on the financial markets escalated, especially with Greek government bonds. In January 2010, the Greek government presented a drastic austerity package to cut their budget deficit from 13 % in 2009 to just 2 % in 2013; this package came about under heavy pressure from the EU Commission and several member states. Furthermore, the European Council established the European Financial Stability Facility on May 9th, 2010. This fund can realise credits up to 440 billion euros available to governments in financial difficulties. With the help of the International Monetary Fund (IMF, 250 billion euros) and the European Commission (60 billion euros) this sums up to a safety net of 750 billion euros. This was supposed to stop speculative attacks on government bonds of some member states. The granting of these credits will depend on tough budget cuts. At the same time, the ECB has signalled to buy government bonds under pressure.

These financial measures bought precious time, speculative attacks were curtailed, and the risk premiums on bonds of struggling states were reduced significantly. At the same time, the euro area countries have committed themselves to a tough, restrictive consolidation strategy for many years, maybe for an entire decade. This strategy will either increase economic imbalances in the euro area or lead to a stabilisation with unsatisfactory growth and employment rates. Again, the crisis' actual causes are not addressed. There is still no institutional structure to mitigate economic imbalances in the euro area. The time gained with the help of the European Financial Stability Facility would be well spent to enable the SGP to effectively help stabilise the euro area, while at the same time encouraging economic growth.

Present-day proposals have faulty focus

The European Union, the ECB and several economists have already submitted reform proposals, reacting to the obvious demand for action. But most of these proposals solely focus on public debt, disregarding private debt.

Since spring of 2010, the European Union has come forward with several consecutive proposals to modify the SGP and to increase surveillance by the Commission. In May 2010, the *European Commission* affirmed that the SGP is the adequate instrument to contain public deficits, but conceded that surveillance measures should be reinforced. At the same time, macroeconomic imbalances should be closely monitored and taken into account (European Commission 2010a). Apart from improved statistical data compilation, the Commission proposes a so-called European semester, i.e. a reinforced surveillance of public budgets before they pass national parliaments. Additionally, sanctions against violations should be tougher and faster, e.g. new penalties could be installed or payments of the European Cohesion Fund could be withdrawn. The SGP should also be incorporated into national law. This tougher surveillance will also take the 60 % debt-to-GDP ratio increasingly into account as a crucial element of the excessive deficit procedure, not neglecting it as in the past. Besides reinforced fiscal surveillance, macroeconomic imbalances should be monitored more closely in order to identify future credit bubbles or competitive disadvantages of member states; both are supposed to be met by structural reforms.

The proposals of the *European Task Force* of Council President Herman van Rompuy partially coincide with these ideas; the Task Force consists of high-ranking politicians of member governments, of the Commission and the ECB. This group has been working since May 2010 and has in the meantime submitted proposals for reinforced fiscal surveillance and for a reduction of competitive disadvantages (van Rompuy 2010): The Task Force also favours the European semester for better budgetary surveillance. Additionally, sanctions should be imposed even before the 3 % criterion is violated, the 60% criterion should be reinforced as well, and closer monitoring should detect countries with internal economic weaknesses or competitive disadvantages. The Task Force proposals have been discussed during the European Council meeting on June 17th 2010 in Brussels and have been included in its Conclusions (European Council 2010, p. 4-5).

The aim of all EU proposals is the compliance of member states in terms of both criteria, the 3 % deficit and the 60 % debt-to-GDP criterion, through early surveillance and tougher sanctions. According to this approach, budget problems arise only when existing rules are not fully implemented by member states. The underlying economic concept of the SGP is never questioned. Neither is adequately taken into account that the sharp increase of national deficits is the result of the financial crisis, particularly of governments compensating for plummeting demand and rescuing private banks and financial institutions, nor is there a discussion whether the attainment of these targets is sensible and feasible in the current situation – if it ever was. In contrast to earlier SGP reform proposals, the focus is, however, widened and a broader macroeconomic surveillance introduced. But again, this surveillance is one-sided, because countries with attested competitive disadvantages will be urged towards dubious structural reforms, while no adjustments are required of countries with current account surpluses. This makes the return to stability exceedingly difficult. Plus, there are no precise and manageable criteria to indicate macroeconomic imbalances.

The *ECB* proposal concentrates on a stricter application of the 3 % deficit criterion as well. Deficit procedures and sanctions should start automatically if this criterion is violated, also if the general government debt exceeds 60 % of GDP. Sanctions could also include the limiting of voting rights in the EU. An independent fiscal institution should be installed within the Commission to monitor and evaluate national budgets. International competitiveness is surveilled to detect decreasing competitive advantages or emerging competitive disadvantages; with this focus, economic imbalances are only located in countries with competitive disadvantages or current account deficits.

The German economists *Clemens Fuest, Martin Hellwig, Hans-Werner Sinn* and *Wolfgang Franz* (Fuest et al. 2010) have published ten rules to rescue the Euro currency in one of the leading German daily newspapers, the “Frankfurter Allgemeine Zeitung”. Again, those rules concentrate largely on public budget deficits and debt. Fuest et al. propose that governments hard-pressed for funds shall receive financial aid only after a unanimous vote in the group of supporting states and the IMF. Also, this aid has to be refunded, plus an additional fee; the sum of financial aid may never exceed a certain percentage of the receiving country's GDP. The country's previous creditors should share the debt crisis' burden through a reduction of their claims, a so-called “haircut”. If a member country is on the verge of bankruptcy, its budget should be directly controlled by the European Commission. The authority of the European statistical agency Eurostat should be extended, the emission of Eurobonds should not be allowed. Leaving the European Monetary Union should be possible at any time, either voluntarily or forcibly. On the financial markets, these measures should lead to add-on interest rates according to each country's credit rating. Reinforced deficit and debt criteria should further promote fiscal discipline: The 3 % deficit criterion should be reduced by one percentage point for each 10 % step that the debt-to-GDP ratio exceeds 60 %. For example, a country with a 110 % debt-to-GDP ratio would require a 2 % budget surplus to meet these new criteria. If the criteria are not met, an automatic fine would be imposed without further political decision making.

The ten rules of Fuest et al. cannot meet the central problems of the euro area, they miss them entirely. If they were applied instantly, we would witness a massive economic downturn in the euro area, because consolidation strategies would be intensified when countries with high debt-to-GDP ratios would suddenly have to meet the adjusted deficit criterion. Again, the one-sided fixation on state finances is astonishing, especially since the authors concede that excessive private debt should be avoided and that foreign trade imbalances in the euro area have been too high in the past. It remains unclear whether the proposed rules could have prevented these

Box 1:
Basic mechanics of sectoral financial balances

In order to identify potential macroeconomic imbalances, it could help to clarify the following accounting identities. The financial balances of the three main economic sectors – the state, the private sector and the foreign sector – have to sum up to zero by definition. Consequently, the sum of the state sector balance and the private sector balance constitute the domestic current account balance.

State sector balance (= the state's revenue minus its expenditure)
+ private sector balance (= private savings minus private investments)
= domestic current account (= negative foreign sector balance)

If a country features a current account deficit (meaning a positive foreign sector balance), this deficit is logically paralleled by negative balances of the state and private sector. On the other hand, if a country has a current account surplus, this implies that the net domestic saving is positive: Either the private sector net saved more than the state's deficit, or the state's net savings are higher than the deficit of the private sector.

developments: No sanctions are imposed against excessive private debt or current account deficits, and no internationally coordinated strategy to meet macroeconomic imbalances discussed. Whether the financial markets would really react to excessive private debt and current account deficits with timely risk premiums for government bonds, i.e. before the development of a debt crisis, in order to discipline the respective governments, is highly unlikely. In this scenario, there are again no incentives to change for countries with sizeable current account surpluses. These rules are merely a reinforced version of the faulty SGP design.

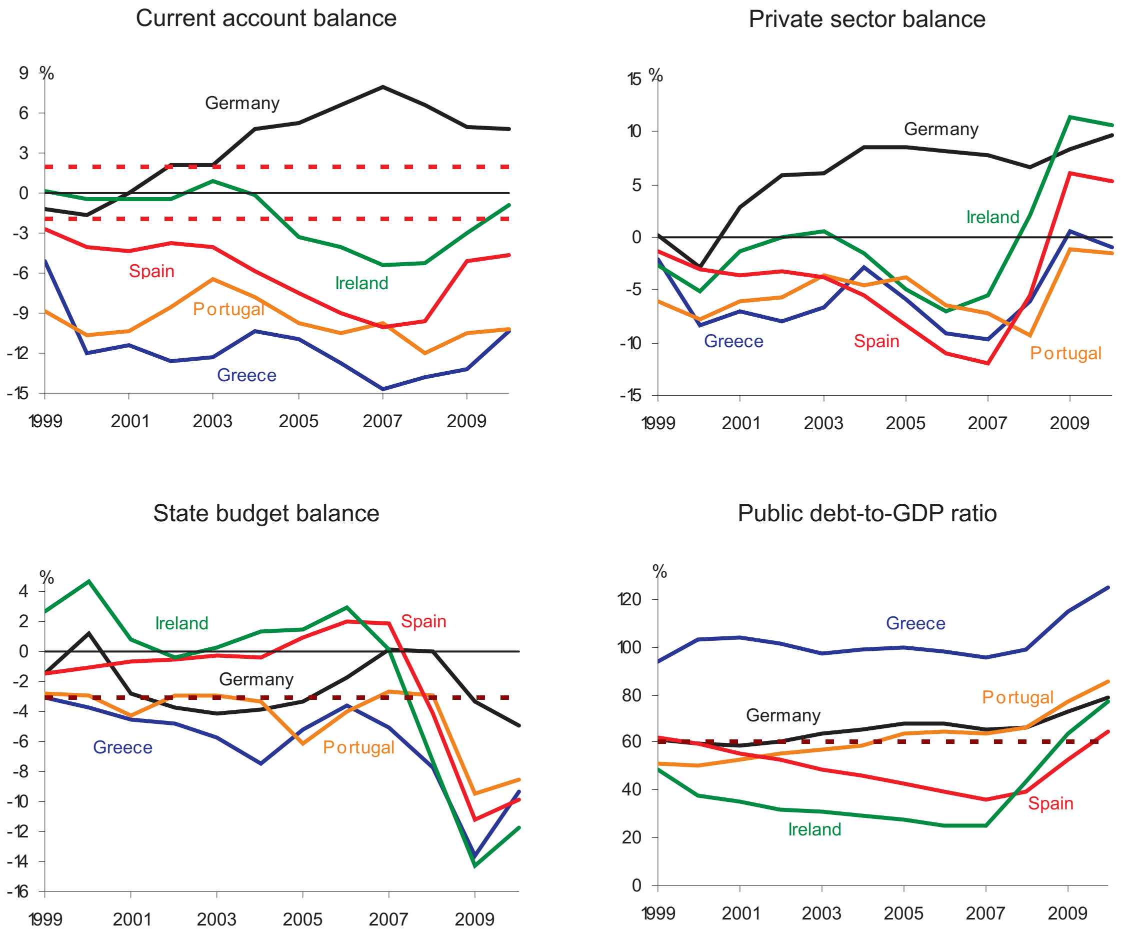
The economists *Daniel Gros* and *Thomas Mayer* propose the instalment of a permanent stabilisation mechanism, the European Monetary Fund (EMF), along with terms for an orderly bankruptcy of insolvent member states. According to Gros/Mayer (2010), the key element of this new EMF would be its contribution rate: Countries with a higher risk of bankruptcy would have to contribute larger sums to the fund. Gros and Mayer write (2010, p. 13): "the potential risk each member country represents (…) increases of course the higher the country's deficits and debt levels." The authors suggest that only countries violating both deficit or debt criteria should contribute to the fund. Hence the same objections apply as to the discussion of the Fuest et al. (2010) proposals: It is not self-evident why Germany would have been required to contribute repeatedly to the fund between 1999 and 2007 due to its excessive budget deficits in several years, while pursuing a restrictive fiscal policy despite large and growing current account surpluses, whereas the massive and growing private (foreign) debt in Spain would trigger no consequences, only because the state deficit was not 'too high'.[1]

All presented proposals uniformly define state deficits as the major problem and adhere to the well-known limits to budget deficits and debt-to-GDP ratios. The recommended measures primarily propose to tighten fiscal surveillance and policies. If they were implemented instantly, they would entail a massive negative fiscal impulse: Because private demand is still weak, further massive budget cuts would probably result in a long-term economic stagnation. In a worst-case scenario, it would even slump the euro area into another recession. Production capacities would be under-utilised, unemployment rates would remain high, long-term economic growth would be endangered, and severe social and political disruption could occur. But we believe there is another reason why compliance with the deficit criteria is not always desirable: The focus of the SGP on public deficits is at fault, the pact concentrates on the wrong criterion. That is why the SGP could neither prevent nor cushion the crisis in the euro area. A country's budget deficit or debt-to-GDP ratio has no systematic effect on the potential risk this country poses to the stability of the monetary union. We will elaborate on this in the next paragraph.

[1] In an Annex, Gros/Mayer (2010, p. 9) develop a "vulnerability index" to describe how vulnerable a country would be in the face of a financial crisis. This index includes, besides the public debt and the public budget deficit, the country's current account balance and its national net savings (all in percentages of the GDP), as well as the nominal unit labour costs. This index would be far more conclusive than public debt and budget deficits. However, it is immaterial to the authors' design of the EMF.

Graph 1

Financial balances of the sectors and public debt in % of GDP
1999-2010



Reference level according to the IMK proposal (± 2 % current account balance).
Reference level of the SGP (3 % deficit criterion and 60 % debt-to-GDP ratio).

Source: AMECO-database of the European Commission (as of April 20th, 2010), for 2010: forecast of the European Commission; calculations by the IMK.

The pact's main flaw

The SGP's main design flaw is the fixation on a single financial balance of one domestic sector, i.e. the state. A country's budget deficit should never exceed 3 % of its GDP as a matter of principle. Over the cycle, public budgets should be balanced or in surplus.[2] The debt-to-GDP ratio is not allowed to rise above 60 %. With this focus, the pact flatly ignores the private sector and foreign trade (see Box 1). The pact indeed sanctions state deficits, but provides no incentives to create budget surpluses during boom times, which could help prevent an overheating of the economy.

[2] A balanced budget over the business cycle implies a continual reduction of the debt-to-GDP ratio, at least if the nominal GDP growth is positive.

This focus on fiscal rules has not been able to avert the current crisis. Graph 1 shows how Spain and Ireland have always complied with the 3 % criterion, from the beginning of the monetary union until 2007. Nevertheless, both countries had severe macroeconomic imbalances, just like Germany and Greece (Graph 1):

- The German economy was defined by a weak domestic demand and an increasing current account surplus. High net private savings accumulated, resulting from low investments and weak consumer spending. At the same time, capital exports were extraordinarily high. The German budget featured deficits between 2001 and 2006, violating the 3 %

Table 1

Public debt, current account and yields on government bonds
2007 and 2010

	Public debt in % of the GDP		State budget balance in % of the GDP		Current account balance in % of the GDP		Yields on 10 year government bonds	
	2007	2010*	2007	2010*	2007	2010*	2007	2010**
Germany	65.0	78.8	0.2	-5.0	7.9	4.8	4.2	3.0
Spain	36.2	64.9	1.9	-9.8	-10.0	-4.6	4.3	4.1
Portugal	63.6	85.8	-2.7	-8.5	-9.8	-10.1	4.4	4.7
Ireland	25.0	77.3	0.1	-11.7	-5.3	-0.9	4.3	4.8
Greece	95.7	125.1	-5.4	-9.4	-14.7	-10.3	4.5	7.4
For information only:								
GB	44.6	79.1	-2.8	-11.8	-2.7	-1.8	5.0	3.9
Japan	187.8	193.5	-2.5	-6.7	4.8	3.1	1.7	1.3
USA	62.2	94.1	-2.7	-10.1	-5.2	-3.8	4.6	3.6

* Forecast of the European Commission; ** average of January – June 2010.

Sources: AMECO-database of the European Commission (as of April 20th, 2010); Reuters EcoWin (Financial database); calculations by the IMK.

criterion between 2002 and 2005. But the net savings of private households and companies together rose distinctly faster than the state's new debt. In the year 2007, the public budget attained a surplus as well, albeit on a smaller scale. The current account balance rose correspondingly from -1 % in 1999 to 8 % in 2007, the debt-to-GDP ratio rose from 61 % to 65 % during the same period.

- In Greece, an opposite development occurred: A strong domestic demand was paralleled by a growing foreign debt. Between 1999 and 2007, the private as well as the public sector exhibited high deficits, which were met by capital imports (current account deficit). The new debt in the private sector was higher than in the public sector. The debt-to-GDP ratio was 96 % in 2007, roughly the same as in 1999 (94 %).
- In Spain and Ireland, the domestic demand was also strong and the foreign debt increased, but at the same time the public debt decreased. In both countries, the new private debt was excessive and the current account showed a massive deficit. The Irish government reached budget surpluses, except for the year 2002 (- 0,3 %), the Spanish at least for the years 2005 – 2007. The public debt-to-GDP ratio dropped from 49 % to 25 % in Ireland between 1999 and 2007, in Spain from 62 % to 36 %.

Even if all member states had uniformly complied with the 3 % criterion for public budget deficits, the crisis could not have been averted, at least not if the significant foreign trade imbalances had not been prevented at the same time. Again, the developments in Spain and Ireland demonstrate this: After adhering to the 3 % criterion until 2007 like well-behaved member states, the crisis let private demand plummet and the governments were forced to assume private debts and adopt a stabilisation policy financed by public debt. The debt-to-GDP ratio sky-rocketed (see Table 1), and suddenly the international financial markets had doubts about the credit ratings of these governments – the very same markets that had readily financed the (private) capital imports in these countries for years.

For everyone who believed the SGP would prevent such a scenario, this must have come as a surprise. The focus of the SGP is solely on public budget balances, according to its own inherent logic. The pact is effectively blind to all imbalances in other economic sectors (see Box 2). This ignorance proved to be fatal, because current account balances signal a vulnerability to speculation attacks far more clearly than public budget deficits. In a country with enduring current account surpluses, the net private saving is usually high. This not only helps to "finance" additional government borrowing, but also builds up claims against foreign economies. This again leads to better credit ratings on the financial markets, along with the government's theoretical access to private savings by means of taxes, duties and contribution rates. Furthermore, a country featuring a current account surplus is evidently able to fulfil obligations to foreign creditors. Because of its international competitiveness, the country is considered reliable. On the other hand, a country with permanent and considerable current account deficits is vulnerable to speculation attacks and financial risks – even if the public budget had been balanced or even been positive over the years. The rationale is that

Box 2:
Consequences of a balanced budget over the business cycle

The present Stability and Growth Pact reflects the widespread idea that the main macroeconomic function of national economic policy is a balanced public budget or even a budget surplus, without ever violating the 3 % criterion. At the same time, the central bank tries to enforce its inflation target – in case of the ECB, below but close to 2 % on average across the euro area. If we assume that the current account balance of the entire euro area is balanced in relation to the rest of the world,[3] the demand for balanced public budgets
logically implies that the desired balance of the European private sector should be zero. If for instance the private households saved more, private businesses would automatically have to invest more. In this implicit model, the coordination of private saving intentions and investment decisions takes place on largely deregulated financial markets. Current account balances between euro area countries are interpreted as equilibrium phenomena, resulting from demographic differences, different timing preferences of private households, and differences in the optimal size of each country's capital stock. None of these differences cause concern or require political interventions.

The only problem is – this model is not realistic. The realised balances of the economic sectors do not necessarily coincide with the anticipated spending targets of all economic agents. Consequently, the sum of all balances is not necessarily zero, not even on average across the business cycle. Even if a balanced budget is aimed for, a public deficit can persist over several years, for instance if the government decides that production should work at full capacity in a situation where a private demand slowdown and positive net private savings occur. For the government, it could seem sensible to fill the gap in demand with increased government expenditure (automatic stabilisers and investments to increase productivity). But also the sector balances can vary in retrospect, in some cases even creating long-term deficits or surpluses. A potential option is for example that demand shortfalls in one or several countries emerge together with positive private and public net savings. In this case, foreign economies can fill the demand gap, creating a notable current account surplus. For this strategy to work, the exporting country's competitiveness has to remain high, including lower price increases compared to its trading partners. The downside for these partners is the threat of a devaluation race which could ultimately result in a deflationary downward spiral – at least if other countries are not willing to increase their public debt through current account deficits. But growing foreign debt can bring about financial fragility and structural shifts in the country's international competitive position. This is precisely why the euro area needs an active and coordinated macroeconomic policy, as opposed to a further deregulation of financial and labour markets combined with macroeconomic abstinence. Deregulated labour markets only intensify the downward wage pressure and would evoke the real danger of a deflationary devaluation race, especially in the current situation.

[3] After the year 1999, the current account of the entire euro area was nearly balanced. There is an ongoing debate that the euro area actually needs surpluses plus the corresponding capital exports, as a provision for its ageing population: The Euro countries should build up a capital stock now to let the future pensioners live off the interests or spend the capital, thus ensuring their future living standard. However, most countries face similar demographic problems; even in China, the number of pensioners rises continually. And the past crises of the complementing countries with high current account deficits and high foreign debt show how precarious these investments can be.

this government can be pressured in every crisis to assume private debt, for instance to stabilise the banking system. The state has to shoulder the negative consequences of any private over-indebtedness crisis, like tax deficits or the costs of stabilisation policies. This inevitably leads to a rapidly rising national debt. Ultimately, it is irrelevant whether excessive national debt was caused by government debt or private debt. If a country exhibits current account surpluses or deficits depends largely on its international competitiveness and the relative growth rate of its economy. Whether a country has its own currency and central bank, or if it has relinquished its right to an autonomous fiscal policy to a monetary union, makes a vast difference. In the first case, it can react to the loss of market shares by nominally devaluing its currency. The EMU has no nominal internal exchange rates, thus only an inflation rate below average can induce real devaluation. This can be achieved if the development of unit labour costs remains below the European average. Compared to a nominal devaluation, this is a very slow adjustment method. As a result, macroeconomic imbalances in a

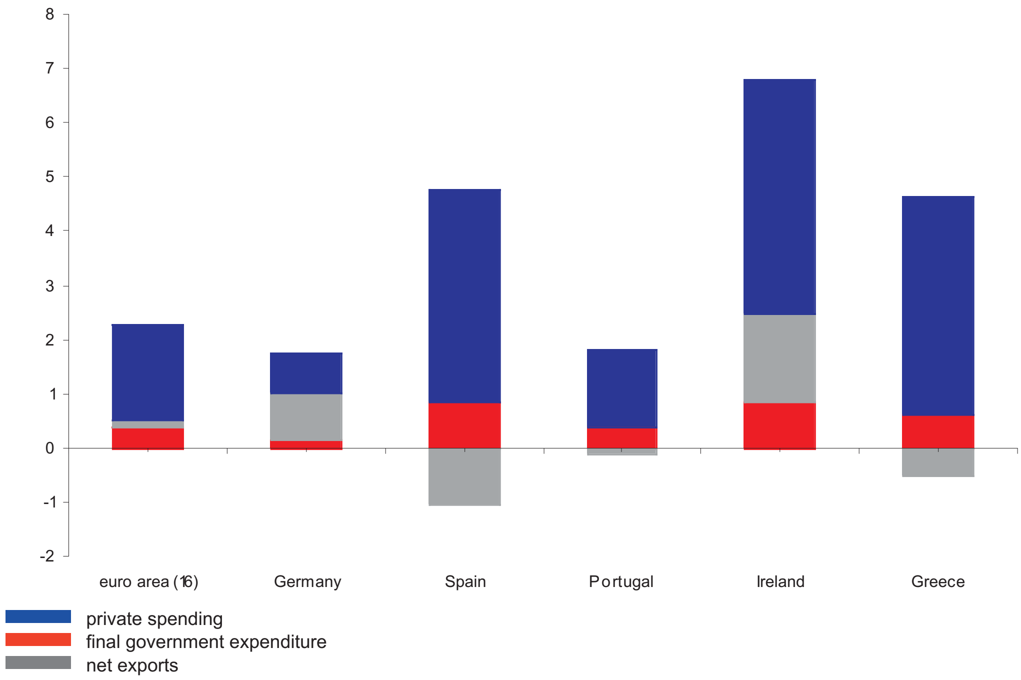
Box 3:
Macroeconomic imbalances in the euro area since 1999

In the first decade of the monetary union, its macroeconomic development was highly imbalanced (see Graph 2). This holds especially true for Germany, Greece, Ireland, Portugal and Spain. Germany had the lowest growth rate of all member states, alongside Italy and Portugal. Germany is also the only country whose net exports contributed more on average to GDP growth than its domestic demand; and in no other euro area final government expenditure contributed so little to GDP growth. The combination of these facts led to high current account surpluses and massive capital exports. This export-oriented strategy could only work because the domestic demand in other member states was stronger: They contributed significantly more to the aggregate demand of the euro area than Germany did – the largest country of the union (accounting for more than a quarter of the euro area-GDP). All along, the euro area's current account is almost perfectly balanced, its imbalances are internal: Germany with its weak domestic demand, rising net exports and increasing current account surpluses on the one side, Greece, Ireland, Portugal and Spain on the other side, with strong domestic economies, rising import surpluses and growing current account deficits.[4]

Diverging wage cost developments in the member states were partly responsible for these imbalances (see Graph 3). Given the ECB's inflation target of 2 %, the nominal unit labour costs would have needed to rise by around 18 % between 1999 and 2007 – this was approximately true for France. In contrast, this figure rose by only 1,8 % in Germany, whereas in Greece, Portugal and Spain, the nominal unit labour costs

Graph 2

Average contribution to the growth rate by sector: private sector, state sector, foreign sector
1999 - 2007



Source: AMECO-database of the European Commission (as of April 20th, 2010); calculations by the IMK.

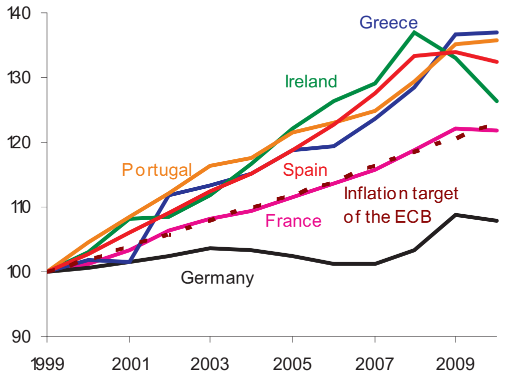
[4] Despite export surpluses, Ireland also showed high current account deficits. For a discussion of the resulting problems, see European Commission (2010b).

increased by 28 % to 30 %. The development of inflation rates also varied greatly among the member states. This again massively influenced the price competitiveness of each country's export industry. At the same time, diverging real interest rates occurred. Countries featuring high levels of competitiveness and low inflation rates had higher real interests rates, limiting investment activities. On the other hand, the high aggregate demand in the deficit countries benefited from their higher inflation rates and consequently lower real interest rates; during the first years of the monetary union, their domestic demand also profited from the decline of capital market interest rates due to lower risk premiums. This is how the severe current account imbalances within the euro area came about.

Furthermore, Germany has followed a separate route in its expenditure policy, compared to other European countries (see Table 2). Germany is the only country, besides Japan, that has reduced its total public expenditure between 1999 and 2007, according to the data of the European Commission. Whereas the ratio of public expenditures to GDP has been about 47 % for all of the EU-15 states during this period, in Germany it has dropped from 48 % to 43 % (called “the decade of denationalisation”, Bofinger 2008). This explains the weak contribution of the state's demand to Germany's growth rate: 0.15 % between 1999 and 2007.

Graph 3

Nominal unit labour costs
1999=100, combined with the reference value implicit in the ECB's inflation target, 1999 – 2010



Source: AMECO-database of the European Commission (as of April 20th, 2010); calculations by the IMK.

Table 2

Government expenditure in selected countries from 1999 to 2007
average annual growth rate in %

	nominal	real[1]		nominal	real[1]
EU-27	4.3	1.7	USA	6.1	3.3
EU-15	4.1	2.0	Hungary	10.2	3.2
EWU-16	3.7	1.6	Slovenia	8.8	3.2
EWU-12	3.7	1.6	Poland	7.2	3.2
Latvia	14.2	9.2	Malta	5.1	2.7
Romania	31.0	8.4	Portugal	5.6	2.6
Estonia	11.9	7.6	Netherlands	4.8	2.4
Ireland	11.0	7.4	France	4.0	2.2
Cyprus	8.9	6.2	Finland	3.6	2.0
Iceland	9.6	5.8	Sweden	3.5	1.9
Lithuania	7.4	5.5	Belgium	3.8	1.8
Bulgaria	11.5	5.0	Italy	3.6	1.3
Great Britain	6.6	5.0	Denmark	3.1	1.1
Luxembourg	7.4	4.5	Austria	2.8	1.0
Greece	7.7	4.3	Slovakia	6.5	0.1
Norway	5.9	4.0	**Germany**	**1.3**	**-0.3**
Szech Republic	6.4	4.0	Japan	-1.6	-1.3
Spain	7.2	3.9			

[1] Deflationed with the (harmonised) consumer price index CPI.

Source: AMECO-database of the European Commission (as of April 20th, 2010); calculations by the IMK.

monetary union cannot be reduced overnight. But we believe that a more balanced economic growth could and should be achieved (see Box 3 for a summary of macroeconomic imbalances in the euro area so far). A reformed SGP could contribute significantly to this development, at least if it addressed current account balances and measures to reduce macroeconomic imbalances.

Crisis management first...

This perspective allows us to define requirements for the short-term crisis management in the euro area as well as for permanent reforms of the SGP. The short-term crisis management requires the following:

1. The fiscal policy of the euro area has to remain more expansionary than the stability programmes of the member states for the years 2010 – 13 specify, and more expansionary than the requirements of the rescue package for obtaining credit designate (see Brecht et al. 2010). Given the considerable under-utilisation of production capacities in Europe and the high unemployment rates, even a significant economic upturn would not be inflationary in the next two years. In the case of a strong self-supporting boom, fiscal policy could quickly finance the expansionary measures through tax increases, accelerating budget consolidation along the way.
2. To help an economic upturn and reduce imbalances, countries with an excessive current account surplus should introduce further expansionary stimulus packages. This holds especially true for Germany, the largest EMU country with an alarming backlog in public investments. A cooperative fiscal strategy like this would mean net advantages for the EMU, and for every member country alike.
3. The ECB has to guarantee the solvency of its member states. Therefore the ECB should continue its willingness to buy long-term government bonds until the current crisis is resolved.

… stability pact reform afterwards!

The proposed crisis management would support economic recovery, avert the threat of national bankruptcy and would prepare for the reduction of imbalances. But the euro area needs long-term stability. For this, the SGP has to be reformed fundamentally. The following six conditions have to be met:

1. The single-minded fixation of the SGP on public budget deficits misses the point. Any fiscal rule thus reduced cannot provide financial sustainability, and will not have positive effects on a country's credit rating on the international financial markets. And as the current crisis has shown, in an extreme crisis, it has to be suspended anyway to prevent a downward spiral. Therefore the 3 % limit on public budget deficits should be dropped completely. Ultimately, budget deficits are beyond any government's control. Deficits are the result of multiple outside influences; most are not controlled by the government. The stability of the entire national economy, not only of the national government, depends far more on the current account balance of each country, not on its public budget deficit.
2. The limit for budget deficits should be replaced by limits for current account surpluses or deficits, for instance plus/minus 2 %.[5] This would be an adequate indicator for insufficient financial sustainability. Because surpluses are the counterpart of deficits and also have undesirable side effects, the current account indicator would be on red alert above + 2 and below – 2 %.
3. The reformed SGP would have a multilevel examination procedure as well. On the first level (inspection level), it would be determined if the current account balance of a country is beyond the 2 % corridor, on the basis of the Commission's analysis. If the balance is within the corridor, the examination is already over. If the balance is outside the corridor, the second level applies (analysis level). Now, the macroeconomic development of the respective country would be scrutinised. Especially the unit labour costs would be examined carefully (and separately: tradable and non-tradable goods), and exports and imports, as well as private and public debt would be analysed.
4. If the Commission decides that a country's development is not sustainable, it would issue advice on the country's fiscal policy (advice level). Countries with current account surpluses would be advised to stimulate domestic demand with a policy mix consisting of a more expansionary fiscal policy, further investment incentives and structural reforms. The goal would be an increase of nominal unit labour costs and a more equalised income distribution in order to boost private consumption. Deficit countries on the other hand would be advised to implement a policy mix with the ingredients of a more restrictive fiscal policy plus incentives to

[5] The current account deficit limit of 2 % would also limit a country's foreign debt to less than 50 % long-term, asuming an annual nominal GDP growth of 4 %. Our limit is somewhat higher than the (weighted, absolute) mean of the two indicators used by the Commission to calculate equilibrium current accounts (European Commission 2010b, p. 28). Dullien and Schwarzer (2009) argue for a limit of 3 %; this would limit foreign debt to 60 %, asuming a nominal GDP growth of 5 %.

save in the private sector. The economy's competitiveness would also have to be increased, through structural reforms, e.g. by competition policy; this applies to price and non-price competition alike. At first, the planning and implementing of this policy mix would be assigned to the affected country. The European Commission would examine the development annually to see if their advice was followed, and if the current account balance is moving in the direction of the two-percent corridor. If the corridor is reached within three years, the examination procedure is over.

5. If the corridor is not reached within three years time, the fourth and last level becomes effective (sanction level). At the recommendation of the Commission, the European Council would mandate a compulsory non-cyclical government expenditure path, with the involvement of the European Parliament (for the expenditure path concept see also Horn/Truger 2005, Hein/Truger 2006).
   - Increased public spending would be demanded of the surplus countries. No tax cuts would be allowed, due to their lower multiplier effect as compared to higher public expenditure If the government had wanted to stimulate business investments with tax reductions or similar incentives, it could have done so during the previous years on the advice level. On the contrary, a more expansionary expenditure path could be flanked by tax increases in order to limit the increase of the budget deficit, according to each country's political preference (balanced budget multiplier). A notable stimulus for the domestic economy is the benchmark for the gradual reduction of current account surpluses. The more private expenditure is prompted by public spending, the faster the current account balance will move towards the desired limits.
   - The governments of deficit countries will have to reduce their spending accordingly, to a predefined lower level. If necessary, the government will have to raise taxes, duties or contribution rates.
   - The expenditure paths and tax increases, if necessary, would remain in effect for three years, even if the current account balances sink below or rise above the defined limits. If the current account balance is within the corridor after three years, there will be no further requirements. If the balance however is still above/below the corridor, new expenditure paths would be issued for the next three-year period.
6. The rescue package from May 2010 for countries on the verge of bankruptcy should be institutionalised and upgraded to a European Monetary Fund (EMF). This new EMF would refinance the debt of countries with financing problems and fund their expenditure programs as long as these countries comply with the rules of the reformed pact. The fund could make loans directly, or by means of guarantee obligations. If a country is already in the sanction phase when financing problems occur, or if their current account balance is below or above the 2 % corridor, the EMF will only lend further money if the country complies with the predefined expenditure path, or with the newly defined expenditure path (see also Bofinger/Ried 2010 for a similar concept, but without explicit reference to the current account). If the government expenditure exceeds the defined path, the government commits itself to automatic (further) tax increases. Non-compliance would result in the EMF's refusal to guarantee future loans. This again implies that the ECB would refuse to purchase these loans. On the bond markets, risk premia would rise and national bankruptcy would be inevitable. An orderly procedure for bankruptcy, debt moratorium and debt conversion has to be devised.

   But the reformed pact would also impose restrictions on surplus countries. On the one hand, they have to contribute to the EMF just like the deficit countries. On the other hand, if their current account surplus exceeds 2 %, they will be forced on a raised expenditure path. These paths should prevent the deficit countries' consolidation strategies being counteracted by similarly restrictive fiscal policies in the surplus countries. Insufficient expenditure of a surplus country would also entail larger contributions to the EMF, plus additional guarantees.

If national bankruptcy is imminent, despite all precautions, this is an extremely serious disruption, affecting all members of the monetary union. Uncertainty concerning the future of the EMU or its member states would increase alarmingly. A single country with its own currency has various means to avoid bankruptcy. Besides spending cuts and tax increases, this would also include currency devaluation. This again would lead to an increased foreign debt. But since international competitiveness would also increase, debt servicing would again become easier. This course of action is impossible for EMU member states. Therefore a procedure for national bankruptcy is necessary as a last resort. And only if a bankrupt state has complied with all requirements of the reformed pact in the previous stages and years, would it be allowed to remain within the monetary union and may expect support from other member states. To violate the requirements of the expenditure path would mean to knowingly endanger the stability of the entire euro area – and discretionary public expenditure can be effectively controlled by governments, as opposed to budget deficits and current account balances.

However, it could always happen that surplus countries refuse to comply with the predefined expenditure paths, thus counteracting the deficit countries' consolidation strategies. The contribution rates of the surplus countries would rise continuously. But with this behaviour, the surplus countries could effectively endanger or destroy the monetary union, especially in case of a large country like Germany. In deficit countries, public debt would rise despite compliance with the expenditure paths, and these additional loans would have to be guaranteed. To adjust to this development, their expenditure paths would be continually reduced. The result would be an economic downward spiral that could end in the collapse of the monetary union. In a scenario like this, it might be reasonable for a deficit country to leave the monetary union voluntarily, maybe even accept national bankruptcy as a consequence. In this worst-case scenario, at least the foreign creditors would have to share the burden of the national debt crisis. This is why the large surplus countries have an exceptional responsibility for the continued existence of the monetary union. Nobody guarantees the survival of the union, it has to be wanted.

Reformed pact restricts public debt

The proposed SGP reform strategy – from an upper limit for budget deficits and debt-to-GDP ratios toward a limit for current account balances – does not deny that high budget deficits of individual member states will have a negative impact on the entire euro area and should be restricted. As discussed before the monetary union was established in politics and economics at length (German Council of Economic Experts 1998), a high budget deficit can practically “incapacitate” the fiscal policy of the affected country, having negative effects on all other member states, particularly during an economic downturn. Widespread doubts about a country's solvency would have more serious consequences and would have to be appeased with guarantees from other euro area members – as happened during the Greek crisis. Therefore, our recommended strategy also restricts public budget deficits, not by means of an upper limit, but by preserving a country's solvency indirectly through current account balance limits. Only a sustainable fiscal policy is compatible with the reformed pact – even without explicit budget deficit and debt-to-GDP ratio criteria. The government can only borrow money and increase its deficit to the extent of domestic private savings, at least without affecting the current account balance. If the budget deficit increases beyond this level, the current account balance would start to slip and would cause a warning signal at -2 %. If the following analysis by the European Commission discerns an emerging macroeconomic imbalance, an expenditure path for public spending would be determined. This path not only reduces the current account deficit, but inevitably the budget deficit as well.

Before the pact became effective in 1999, there was a widespread apprehension that an expansionary fiscal policy could result in a rising inflation rate (Stark 2001, p. 78 - 9); the reformed pact can disprove all concerns in this direction. Whenever an expansionary fiscal policy would have an inflationary effect, the current account balance would become negative and the new current account criterion would be violated. But even a fiscal policy creating government surpluses could be overly expansionary during an economic boom. If monetary policy is identical for all members of the euro area, only fiscal policy can react to an economic overheating on a national level; the joint European monetary policy always refers to the euro area average. Whenever the inflation rate rises, national fiscal policy is evidently not restrictive enough and the country's current account deficit falls below the -2 % margin – this scenario is not provided for under the present pact.

Another widespread apprehension is that a prescribed expenditure path for the Euro countries would undermine their budgetary sovereignty, a core democratic principle. But actually the proposed reforms do not constrain the countries' fiscal authority any further than the old SGP, which pressured countries with excessive deficits to reduce their debt. We have to acknowledge the following universal rule: Without adequate measures to limit current account imbalances, a monetary union of sovereign states is unviable. Our proposed expenditure path strategy would only provide the essential minimum of fiscal coordination. If the EMU seeks a more effective macroeconomic policy with greater democratic legitimacy, there is no way around a Europeanised economic and fiscal policy – moving ultimately in the direction of a political union.

Conclusions

The present Stability and Growth Pact focuses on the wrong criterion. Instead of its fixation on public deficits, the pact should have concentrated on current account balances – these reflect developments in the public and the private sector alike. If this had been taken into account, the extensive economic imbalances in the euro area could not have soared the way they did, and the effects of the financial crisis would have been dampened.

In the present situation of a fragile economic recovery, the planned tough consolidation programmes would be counterproductive and could even undermine any recovery. Initially, the focus on current account balances implicates higher public budget deficits in some countries. In the long term, the proposed limits for current account balances also curb public deficits. Another advantage of the proposed strategy is that the macroeconomic imbalances in the euro area are finally tackled systematically. Deficit as well as surplus countries would have to contribute to the reduction of these imbalances.

References

Bofinger, P./Ried, S. (2010): A New Framework for Fiscal Policy Consolidation in Europe, German Council of Economic Experts, Working Paper 03/2010.

Bofinger, P. (2008): Das Jahrzehnt der Entstaatlichung, in: WSI Mitteilungen 7/2008, p. 351-7.

Brecht, M./Tober, S./van Treeck, T./Truger, A. (2010): Squaring the circle in Euroland? Some remarks on the Stability and Convergence Programmes 2010-2013, IMK Working Paper 03/2010.

Dullien, S./Schwarzer, D. (2009): Die Eurozone braucht einen außenwirtschaftlichen Stabilitätspakt, in: SWP-Aktuell, 27.

European Central Bank (2010): Reinforcing economic governance in the euro area. June 10th, Frankfurt, Germany.

European Commission (2010a): Reinforcing economic policy coordination, Communication from the Commission to the European Parliament, the European Council, the Council, the European Central Bank, the Economic and Social Committee and the Committee of the Regions, COM(2010) 350 final, Download: http://ec.europa.eu/economy_finance/articles/euro/documents/2010-05-12-com(2010)250_final.pdf.

European Commission (2010b): Surveillance of Intra-Euro-Area Competitiveness and Imbalances. European Economy 1|2010, Luxembourg.

European Council (2010): European Council Meeting on June 17th, 2010, EUCO 13/10 - CO EUR 9 - CONCL 2, Download: http://ec.europa.eu/eu2020/pdf/council_conclusion_17_june_en.pdf.

Fuest, C./Franz, W./Hellwig, M./Sinn, H.-W. (2010): Zehn Regeln zur Rettung des Euro, Frankfurter Allgemeine Zeitung, June 17th, 2010.

German Council of Economic Experts (1998): Wachstum, Beschäftigung, Währungsunion – Orientierungen für die Zukunft. Annual expert report 1997/1998, Wiesbaden, Germany.

Hein, E./Truger, A. (2006): Europäische Finanzpolitik: Ausgabenpfade als konjunkturgerechte Alternative zum Stabilitäts- und Wachstumspakt, IMK Report no. 10.

Horn, G./Truger, A. (2005): Strategien zur Konsolidierung der öffentlichen Haushalte, in: WSI Mitteilungen, 58(8), 2005, p. 425-32.

Stark, J. (2001): Genesis of a Pact, in: Brunila, A./ Buti, M./Franco, D. (eds.): The Stability and Growth Pact. The Architecture of Fiscal Policy in EMU, Houndsmills, Basinkstoke, Hampshire: Palgrave, p. 77-105.

van Rompuy, H. (2010): Remarks following the second meeting of the Task Force on economic governance, download: http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/114979.pdf.

Published by: Macroeconomic Policy Institute (IMK) at the
Hans Böckler Foundation, Hans-Böckler-Str. 39, 40476 Düsseldorf, Telephone +49 211 7778-331,
Fax +49 211 7778-266, IMK@boeckler.de, http://www.imk-boeckler.de

Managing Editor: Prof. Dr. Gustav A. Horn
Press officer: Rainer Jung, +49 211 7778-150

Hans **Böckler Stiftung**