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Why the *Pact* Has No Impact

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Why the Stability and Growth Pact ultimately made no significant difference to the fiscal behavior of the eurozone major member economies.

A constraint on the euro's rise to international prominence has been the underperformance of the major eurozone economies (France, Germany, and Italy), and their apparent lack of fiscal discipline, ignoring the Stability and Growth Pact in response to their recent recessions. Seen through some European eyes, the disregard for the rules of eurozone budgetary conduct is both a failing of these national governments and a threat to the viability of the eurozone. It is neither.

For these governments, unwillingness to adhere to the Stability and Growth Pact or to undertake major fiscal consolidation is a rational, if not optimal, response to economic realities. On the one hand, France, Germany, and Italy had the most to lose from giving up fiscal stabilization policy, because they were the European economies in which such policy would be most effective. There is a strong positive correlation between a developed

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High Early Hopes: *The signing of the Maastricht Treaty, July 2, 1992.*

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economy's size and its fiscal responsiveness to business cycles, and a strong negative correlation between developed countries' openness and their fiscal responsiveness. In short, the countries most likely to benefit from fiscal policy rather than see its impact spill abroad are the ones that use fiscal policy the most.

On the other hand, these European economies are not candidates for Rubinesque virtuous cycles from fiscal consolidation to investment booms to growth back to budget surpluses (à la the United States in the 1990s). For expansionary consolidations to work, several factors are required. Interest rates must respond strongly to fiscal consolidation, which usually requires a high initial debt-to-GDP ratio and/or significant foreign-held debt. Business investment must respond strongly to interest rate reductions, which usually involves forward-looking and flexible corporations. Growth in productivity and employment must respond strongly to the increases in investment. And, to complete the cycle, government revenue must respond strongly to the increase in growth. (A little accompanying monetary accommodation does not hurt, either.)

Though these attributes did characterize the United States in the 1990s, they did not and do not characterize the large continental European economies, given their well-known structural problems. The initial debt conditions were seen only in Italy. And if there is no obvious near-term growth benefit from fiscal consolidation, the yielding of monetary sovereignty by national central banks to the European Central Bank makes the loss of national fiscal discretion to the Stability and Growth Pact more costly and increases these eurozone member nations' output volatility.

Bond markets alone cannot be the enforcement mechanism of the rules, for if those markets' sanctions were sufficiently scary to the governments, there would be no need for the rule in the first place.

Thus, there was more to the Pact's breakdown than the oft-claimed but undocumented asymmetry of government behavior with respect to budget policy and the business cycle. In fact, an analysis shows that the introduction of the euro (and attempts to enforce the Stability and Growth Pact) had no impact on the counter-cyclicality of eurozone members' fiscal policy compared with the pre-1992 responses of their budgets to the business cycle. Even during the run-up to euro membership covering a time of expansion for most EU economies, budget positions did not improve more than the usual pro-cyclical factors would account for.

German budgets were indeed more counter-cyclical in 1992–2003 than expected from a forecast based on past behavior, but were so symmetrically on both the up and down cycles. France as well appears to have become more counter-cyclical since the adoption of the euro in 1999 than expected based on past behavior, but again in both directions, not simply towards ease. Italy's fiscal behavior post-Maastricht is fit well by an estimated reaction function for the entire post-1960 period, only deviating towards surplus in 1997, as one might expect with one-off privatization measures to show motion towards the Maastricht targets.

The eurozone supposedly needed the Stability and Growth Pact for four reasons: one, to prevent profligate national governments from issuing more public debt in hopes of a bailout from the ECB and/or free-riding on more disciplined countries' credit ratings; two, to limit the degree to which member countries would expand their public debt after entering the eurozone, having squeezed to meet the Maastricht criteria; three, to maintain long-run price stability and the autonomy of the ECB by preventing fiscal erosion; and four, to encourage

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national economies to continue with structural reform during contractions rather than relying on the perceived easy out of expanding government programs. All of these were worthwhile goals, but their connection to the Pact was based on some dubious assumptions.

Most dangerous among these assumptions were three. First, it was assumed that punishments for pact violations would be credible, despite their relying on peer review in Ecofin (the council of economic and financial ministers). As amply demonstrated in the first instances where they might apply, they were not. Second, underlying the previous assumption in practice, was the assumption that the major eurozone economies would be largely in sync with the monetary policy set by the ECB for the zone as a whole, thereby minimizing the need for such fiscal deviations and punishments.

In recent years, the opposite unluckily turned out to be the case, with Germany and Italy being most visibly out of sync with ECB policy on the side of excessive tightness. Of course, most American observers were unsurprised that discretionary fiscal policy would become more, not less, necessary once monetary independence was sacrificed by Germany and to a lesser degree by the other eurozone members.

Third, and perhaps most critically, the assumption was made that the loss of counter-cyclical policy by the national governments would be accepted in any event. It was thought both that the 3 percent of GDP room allowed for automatic stabilizers would prove sufficient for most downturns, and that the benefits of expansionary consolidations would become evident (and buy off opposition). Neither proved to be the case, with a sharp but not historic recession in 2001–03 justifying greater response than the Stability and Growth Pact allowed, and no sign of any investment or productivity boom in those countries whose interest rates dropped upon meeting the Maastricht criteria and entering the eurozone.

In a particularly telling example, the Italian case should have been the poster child for the benefits of fiscal consolidation through eurozone membership. Whether because euro entry raised the prospect of free-riding by Italy on Germany's credit rating, or of greater discipline on Italian fiscal policymakers by tying their hands (the idea that motivated Italian elites' advocacy of the euro from the start), Italy was suddenly able to issue private- and public-sector debt at a much lower interest rate. Of course, its very high initial debt/GDP level also made it a seeming candidate for a Rubinesque virtuous cycle—not least because debt-service payments were a non-trivial part of GDP and the government budget, and part of that debt was foreign-denominated.

Yet, Italy's experience since getting serious about meeting the Maastricht fiscal criteria in 1997 and joining the euro in 1999 illustrates very well the channels blocking any consolidation from becoming expansionary in the major euro zone economies, at least in the medium-term. No boom in investment, growth, or productivity has ensued to date. In fact, Italian private-sector investment does not seem to have responded to the drop in interest rates, averaging growth of 2.6 percent per year 1994–98 versus 1.6 percent per year 1999–2003. Over the last twenty years, the Italian unemployment rate declined slightly and then plateaued at a high rate, while productivity growth stayed on a slight downwards trend, irrespective of Maastricht in 1992 and eurozone membership in 1999.

The Italian gross public debt-to-GDP ratio only fell from a high of 134 percent to 117 percent, and has since remained largely unchanged, despite the marked decline in interest rates reducing outlays for debt service, a lot of one-time asset sales and privatizations, and the existence of the SGP. Ultimately, real GDP growth declined on average in the 1990s after the

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short-term boost from adjusting the ERM peg in 1992–93—again despite the fact that Italy had more to gain from the credibility bonus of eurozone membership and ending of currency risk than perhaps any other economy.

A more detailed assessment of performance would also have to take into account that Italy entered the eurozone with an undervalued currency, particularly against the deutschemark, given Italy's exit from the ERM and depreciated re-entry in the mid-1990s. That should have led if anything to temporarily faster growth and lower unemployment in the early years of the euro. This means that the beneficial effects of interest rate declines were even smaller than those implied by the aggregate numbers. And if that is all Italy got, Germany and France with already the lowest interest rates in Europe got even less out of the fiscal aspects of eurozone membership.

So the repeated violation of the Stability and Growth Pact by France, Germany, and Italy makes perfect sense from their economic self-interest. Still, some would argue the Pact should have been enforced nonetheless, as the European Commission understandably did. Just as it is worth noting the revealed preference of national policymakers with regard to fiscal policy, though, there was also a significant gap between the concerned response of the Commission, who are the delegated monitors of the Pact, and the tepid responses of the financial markets and European popular opinion, who are the ultimate enforcers of fiscal discipline. Ultimately, the combination of less-than-credible threats and benefits of the Stability and Growth Pact did not provide sufficient incentive for Eurozone member governments to adhere to the Pact under the current strained, but hardly unlikely, circumstances, and the other priorities they had for fiscal policy.

This illustrates a general problem with fiscal rules. Ultimately, for fiscal rules to work, there either must be a benefit from adherence to the rules that shows up sufficiently strongly and credibly for some groups in society to insist on enforcement of the rules, or the rules must themselves be enforced by threats and if necessary punishments from an outside authority. The declared existence of a rule itself does not become self-enforcing, whatever the claims about reputational or long-term effects, if the incentives are not present. Bond markets alone cannot be the enforcement mechanism of the rules, for if those markets' sanctions, such as increases in interest rates in response to budgetary laxity, were sufficiently scary to the governments, there would be no need for the rule in the first place.

As we have seen, the Stability and Growth Pact fails on both counts to be a viable rule: the unlikely benefits of expansionary consolidation in the eurozone context are not credible while the very real benefits for large, less open, eurozone members to use countercyclical policy to offset the loss of monetary autonomy are. The European Commission does not have sufficient authority to impose punishments on eurozone member states, and the member states have no interest in punishing themselves—especially in the absence of market or popular political outcry. This would explain why the Stability and Growth Pact ultimately made no significant difference to the fiscal behavior of the eurozone major member economies.

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This outcome is not peculiar to the Stability and Growth Pact, however, or an indication that careful tweaking of the Pact's rules and design would change that outcome. In general, fiscal rules that seem to work are more often indicators that a will to pursue fiscal consolidation exists in a powerful political coalition, rather than the rules being causal factors of consolidation in and of themselves.

Take the example of PAYGO rules in the United States in the 1990s. These rules required that new direct spending and revenue legislation in the federal budget process be deficit neutral. This constituted a useful rhetorical device and means of coordination between the President and Congress over budget issues, once the President and a working majority in Congress agreed that they wanted deficit reduction—but PAYGO was also tossed aside when changing circumstances (and a changed President and Congress) led to less desire for deficit reduction. While the rule did not leave the books immediately, when the desire for fiscal rectitude waned, tactics to get around PAYGO emerged, and then PAYGO itself receded.

Putting it graphically, one may reach for a blanket in bed when one wants to be warmer, and the blanket does help one stay warm, but one will throw the blanket off whenever one gets too hot—the blanket cannot force the sleeper into staying at the temperature the blanket allows. To extend the metaphor into the current eurozone context, the Stability and Growth Pact may be the ECB's and EC's security blanket about fiscal developments, but as with Linus' blanket in the "Peanuts" comic strip, its only service may be as a psychological comfort, not as a source of actual security itself. And since, unlike Linus, we expect the euro to age and mature, we should expect it to throw away its blanket as soon as it figures out the harm to its image of dragging around an apparently useless object. ◆