PANEL DISCUSSION

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A never ending debate

When the Treaty of Maastricht was agreed over two decades ago, after a lengthy debate among EU Member States, no one probably expected that the EMU fiscal framework would have been subject to a nearly continuous debate and would have been repeatedly modified. Extensive reforms were introduced in 1997, 2005 and in 2011-12. In parallel, the European Council and the European Commission kept working on the definition of procedures and the interpretation of rules. It has been an incremental process, with new rules adding to previous ones, marked by accelerations and sudden changes, under the pressure of economic and political developments.

These developments and the uncertainty about the end point of the process reflect the novelty of EMU: a single market and a single currency are associated to multiple budgetary authorities. It is a voyage into uncharted waters.

From the very first, the single currency project in Europe was conditional upon gradual progress towards more integrated markets and increasing economic convergence. One of the key aspects was the completion of the single market in 1992, as indicated in the Single European Act of February 1986. When the rules for eligibility and multilateral surveillance were laid down in the Maastricht Treaty in December 1991, two features became evident: i) the pivotal role of nominal stability in the selection of the convergence criteria required for membership of the single currency area and ii) the dominance of the coordination and surveillance of national policies with respect to collective policy formation as a tool for preserving stability over time. In this framework, the commitment of national governments to fiscal discipline was essential, as shown by the Treaty's excessive deficit provisions.

In 1992, the Treaty establishing the European Community introduced the deficit and public debt conditions for joining EMU. In 1997, the Stability and Growth Pact (SGP) defined rules to accompany EMU on a permanent basis. The general government deficit should not exceed 3 per cent of GDP save in exceptional circumstances, on a temporary basis and for a limited amount. Countries should set a medium-term objective (MTO) for the deficit either close-to-balance or in surplus in structural terms, enabling stabilizers to operate freely, combining soundness and stabilization. Multilateral surveillance is to operate via medium-term programmes (stability programmes), the excessive deficit procedure (going from early recommendations to financial sanctions) and the common statistical framework.

The weak points of this arrangement soon became clear: the incentives and disincentives in good times were weak, and there was no independent enforcer (no federal government). These problems emerged clearly in the extensive crisis of 2002-04: several countries had deficits exceeding 3 per cent of GDP, debt ratios in some countries went above the threshold of 60 per cent, the application of the rules appeared to reflect contingent events and needs, the extensive use of temporary measures endangered the credibility of rules, and there were problems with the statistical framework, such as large ex-post revisions of key data.

The 2005 reform of the SGP gave greater importance to cyclical issues and long-term sustainability, increased flexibility in implementation, revised the clause for exceptional circumstances and introduced country-specific MTOs. It also called for the development of national budgetary rules and greater involvement of national parliaments. The reform increased

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complexity and the scope for discretion, loosening EDP criteria and deadlines. The focus remained on fiscal issues, and macroeconomic imbalances continued to get little attention.

A view from 2005

In 2005, in the concluding paragraphs of our book on "Fiscal Policy in Economic and Monetary Union. Theory, Evidence and Institutions", Marco Buti and I noted, "Whatever judgment is ultimately made regarding the revision of the Stability and Growth Pact, it would be wrong to assume that the Pact will become irrelevant. First, the reasons why fiscal rules were adopted in a monetary union of many sovereign countries in the first place are still valid. The future enlargement of the euro area to Central and Eastern European countries actually strengthens the need for a common fiscal framework. Second, as shown by the debate on the reform of the Pact, no viable alternative to a credible supranational rule emerged, since all the other potential solutions came up against serious criticism of one kind or another. Third, many countries need sound fiscal policies leading to a reduction in debt levels also for purely domestic reasons – particularly the demographic shock which lies around the corner: an external anchor may continue to be useful for many countries. Finally, it is likely that, as soon as serious imbalances emerge in some countries threatening the stability of the euro area, the other euro-area members will step up the pressure for rigorous implementation of the rules.

Therefore, in our view, the Stability and Growth Pact will not become yet another ineffective coordination process that, after a burst of attention, fades away and de facto be forgotten. This does not mean that with the agreement of March 2005 the controversy over the Pact will be laid to rest. On the contrary, as rules are necessary in a monetary union, but as such put a constraint on national choices, it can safely be predicted that the revised Pact will remain at the core of policy debate in Europe and that there will be no shortage of proposals for the 'reform of the reform'."

We also stressed that the crucial test would have been the capacity of governments to exploit the cyclical upswing to acquire adequate safety margins and noted that we cannot rely only on EU fiscal rules. We argued that we also need: (a) strong national budgetary institutions, rules and procedures, (b) market discipline (the issue being how to make it more gradual), (c) policy coordination (from peer pressure to EU investment and stabilization funds), possibly leading to federal institutions and policies. Finally, we emphasized the need for more fiscal transparency (concerning, inter alia, off-budget liabilities, cash and accrual data, projections, sustainability indicators) and for independent statistical offices and institutions informing the public and the markets.

Several years later: old problems, new problems

Fiscal risks have actually materialized: the SGP did not guarantee the adoption of prudent fiscal policies in good times; some countries failed to build adequate buffers in good times. New problems became prominent. There were no procedures for managing sovereign debt crisis: this created uncertainty and increased the time required to reach a solution. The interaction of sovereign debt and banks proved very problematic, creating funding problems for banks or the deterioration of public accounts due to the cost of rescue. The focus on fiscal issues proved insufficient. Fiscal imbalances are not the only critical factors in a monetary union; macroeconomic imbalances can undermine fiscal sustainability and sharpen financial tensions: part of private debt often becomes public debt (Franco and Zollino, 2014). Macroeconomic imbalances were not properly monitored.

Most of the weaknesses and vulnerabilities unveiled by the sovereign debt crisis were known long before the inception of EMU. Attention was directed to the adverse effects of macroeconomic imbalances and lack of structural cohesion among Member States as far back as the Delors Report, not to mention a number of academic papers. However, the rules were ineffective initially, because they focused almost exclusively on fiscal discipline and, absent an independent enforcer, their implementation often depended on contingent events. Although the rules were later amended, the critical implications of macroeconomic imbalances for fiscal sustainability as well as for financial stability were largely neglected.

Progress in market integration and economic convergence since the inception of the EMU may have played a role. The evidence shows that disparities greatly abated as candidate members resolutely sought to attain the numerical targets for EMU membership, and the trend continued right up to the financial crisis, which provoked a general halt to convergence if not a regression. Nevertheless, the moderately increasing convergence in such variables as inflation and lending rates did not extend to productivity and economic growth. Accordingly, the divergence in external competitiveness widened, and since the mid-2000s, internal imbalances worsened. Moreover, although the European institutions realized that enforcing fiscal discipline, though necessary, was not sufficient to preserve macroeconomic stability, no major institutional reform was attempted prior to the outbreak of the crisis.

A broad reform effort

In recent years, European policy makers tried to cope with the new challenges by introducing further, and more radical reforms. Fiscal rules were strengthened with the introduction of the European semester; with the Six pack introducing an expenditure rule, a debt reduction rule, reverse majority voting and sanctions in the preventive arm; with the Two pack strengthening the coordination and surveillance of budgetary policies; with the Fiscal compact requiring a structural balanced budget in national legislation and an automatic correction mechanism for offsetting slippages. Monitoring and correction of macroeconomic imbalances were enhanced by the new procedure introduced with Six Pack. New financial support mechanisms were also introduced: EFSF in 2010: ESM in 2011. Finally, banking union was launched in 2014. Altogether, this is an enormous progress. It shows that the EU can react to challenges and move forward with great determination.

Several problems are still open. For instance, the multiplicity of fiscal rules makes the EU framework difficult to manage and to be understood by national policymakers. In particular, one may consider whether we really need an expenditure rule. National expenditure rules can play an important role at the national level and complement the EU rules concerning the deficit and the debt. National governments can control spending more than revenue and deficit, which can lead to greater accountability. Moreover, expenditure rules do not hamper stabilisers on the revenue side, which is consistent with tax smoothing and cyclically adjusted targets, and expenditure rules can curb the tendency to increase spending in upturns. Finally, expenditure rules can be easily explained and monitored and can link the annual budgetary process to a multi-annual policy framework.

The use of expenditure rules in a multinational context, such as the EU, appears more problematic (Buti *et al.*, 2003). First, uniform spending rules would impose homogeneous social preferences to politically heterogeneous countries while country-specific rules would be difficult to enforce. Second, spending norms do not refer to the fiscal variables that can produce negative externalities. While a rising deficit or debt level in one country can create area-wide problems, a rising expenditure level as such does not have negative repercussions on other countries. Moreover, expenditure rules cannot prevent deficit and debt increases stemming from tax cuts. Therefore, they would have to be complemented by a deficit or a debt rule. Finally, the size of the budget typically reflects the political preferences of the government. A new government may want to renegotiate the commitments of its predecessor.

Some technical aspects of the EU fiscal framework remain problematic. For instance, the use of cyclically-adjusted figures has sometimes proved problematic (Franco and Zotteri, 2011). In particular, estimates of output gaps have frequently been revised, sometimes significantly. When they have been revised upwards (*i.e.*, becoming less negative), the cyclical component has been overestimated, with an underestimation of the cyclically-adjusted deficit. Additional problems may arise from the fact that revenues sometimes fluctuate more than would be expected on the basis of the GDP cycle, for instance due to movements in asset and commodity price. These fluctuations cannot be easily dealt with by standard methodologies for cyclical adjustment. Revenue windfalls and shortfalls may offer room for expansionary policies in good times and require pro-cyclical contractionary policies in bad times. These problems do not suggest the abandonment of cyclically-adjusted figures, rather their use with some degree of caution. Independent scrutiny of fiscal policy and good information to the public would also be useful in tackling this problem.

Rules that are more automatic and a strengthened role for the Commission will certainly help in coping with the new challenges. Still, for a long time there will no European federal government enforcing the rules. Moreover, the EU budget will most likely remain small. The introduction of new rules at the national level is certainly useful, but ownership of the new rules should not be taken for granted. National fiscal rules can make policies more time consistent, contribute to fiscal discipline and facilitate stabilisation. However, rules are not a magic wand. Governments can choose to override (either explicitly or implicitly) their own rules. A number of factors (cyclical developments, unexpected shocks, structural changes) may require adjustments of the rules, which can endanger their credibility. Rules can only work if they are grounded on a comprehensive fiscal framework and high transparency standards. They can be successfully implemented over a long period only if public opinion considers them a valuable contribution to policy making. The success of fiscal councils should also not be taken for granted.

It is very likely that financial market discipline will remain crucial. While it would be extremely risky to replace fiscal rules with market mechanisms, greater transparency in fiscal accounts would allow markets to complement rules.

In the end, the success of EMU will rely on the strengthened EU rules, on national fiscal frameworks and on the pressure exerted by financial markers. It will also rely on the capacity to correct unsustainable imbalances. In this regard, one should not forget that the correction of macroeconomic imbalances is primarily a national responsibility and is in the national interest.

Coming challenges

One should not underestimate the coming challenges. When MTOs have been achieved, there will be plenty of room for counter-cyclical policies, but in the transition to the MTOs policies may result pro-cyclical. Moreover, countries will have to be ready for the rise in interest rates in coming years. They will need sound primary balances and adequate growth rates. In order to meet the impact of ageing, many countries should have reduced their debt ratios (to swap lower interest spending for higher pension and health spending). In several countries this has not been the case so far. Finally, there are political tensions. In many countries, the public seem increasingly dissatisfied with the EU.

Fiscal developments will certainly be important, but macroeconomic developments will be crucial. Several countries should tackle the growth issue, being aware that higher deficits do not buy higher growth in the medium term. Structural reforms enhancing competitiveness will be decisive. This is primarily a national responsibility, but the EU can help via the surveillance of macroeconomic imbalances. This is probably the main challenge at the EU level: it implies interfering with economic policy at the national level in a very broad sense. In the end, it implies an extensive EU evaluation of national policy making. This opens a number of issues. First of all, measures to prevent macroeconomic vulnerability are quite controversial. For example, the same values in current account balances or house price changes may have different relevance depending on country-specific factors. In this respect, developments that can be considered growth-enhancing and welfare-improving today may harbour the seeds of harmful imbalances if the general situation changes, due to either domestic or external shocks. Moreover, it is not straightforward to design policies to address the instability risks detected. Indeed, different mixes of factors may underlie the macroeconomic vulnerabilities, and the identification of policy priorities may be controversial. Structural reform is particularly challenging, in that the beneficial impact on macroeconomic imbalances is hard to assess and may be slow in emerging, and possibly even with an adverse impact in the short run. In the case of unsustainable asset inflation, for instance, it is notoriously difficult to identify a bubble before it bursts, and preventive action would carry the political cost of curbing the economy's growth prospects. Accordingly, policy recommendations to prevent and correct macro imbalances can be hardly unequivocally identified by theoretical analysis, and in the current institutional set-up they may hinge on the political economy of inter-governmental competition, as well as on contingent events and needs. Finally, one should consider whether macroeconomic monitoring should be carried out by the same institutions in charge of enforcing fiscal rules and along similar lines.

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