The changes to the Stability and Growth Pact

At its spring meeting on 22 and 23 March 2005, the European Council agreed to fundamental changes to the Stability and Growth Pact which crucially weaken the pact's rules for a sound fiscal policy. The outcome of these decisions will jeopardise the aim of achieving sustainable public finances in all EU member states participating in monetary union. Not only do stable underlying fiscal policy conditions make a contribution to sustained economic growth, they are also needed to cope with future problems stemming from demographic developments. A particular worry from the perspective of a central bank is that public finances which are not lastingly sound make a stability-oriented monetary policy difficult. It is now a matter for the national governments, by pursuing a prudent fiscal policy, to dispel fears that the amendment of the pact implies effectively abandoning the objective of sustainable government financesy.

At a special meeting on 20 March 2005, the Ecofin Council adopted a report to the Heads of State or of Government entitled "Improving the implementation of the Stability and Growth Pact". This document was approved by the European Council at its spring meeting in Brussels on 22 and 23 March 2005. The only matter that is undecided is the technical implementation of the decisions within the fiscal framework. That is to be done in the next few months up to the end of June 2005.

The changes to the pact affect three areas, although the implications of these are by no means of equal significance. The improvement of economic policy cooperation between the European Commission, the Council and member states does not pose any problems. From the Bundesbank's point of view, it is disappointing that the preventive arm of the pact was not substantially strengthened. The weakening of the excessive deficit procedure is a cause for concern.

Change to the preventive arm of the pact

Definition of medium-term budgetary objectives

The concept of a budget that is "close to balance or in surplus" is replaced by country-specific "medium-term budgetary objectives". These are to be determined on the basis of the debt ratio and potential growth and to be revised after no more than four years. Adjusted for cyclical effects and the impact of "one-off" measures, medium-term deficits of up to 1% of gross domestic product (GDP) may be specified for countries with high growth rates and low debt ratios. Targets are set only for euro-area countries as well as countries pegged to the euro in the European Exchange Rate Mechanism.

Adjustment path to medium-term budgetary objective

An annual consolidation of 0.5% of GDP, adjusted for cyclical effects and "one-off" measures, is required of member states that fail to achieve the medium-term objective. The rate of consolidation may be smaller during economically "bad" times. However, the member states undertake to consolidate their government budgets more vigorously in "good" times and to use unexpected revenues to reduce deficits and levels of debt. "Good times" are defined as periods in which output exceeds potential. Any deviations from the adjustment paths are to be explained, and, if necessary, the Commission may issue recommendations for further action.

Taking account of structural reforms

The member states are permitted to diverge temporarily from their given medium-term budgetary objective or path of adjustment. In this context, account may be taken of reforms which lead to an improvement in the long-term sustainability of public finances. The necessary cost-benefit analyses are to be submitted by the member states as part of their stability and convergence programmes. Particular consideration is to be given to reforms of the pension systems.

Changed implementation of the deficit procedure

Article 104 (2a) of the EC Treaty allows the reference value for the deficit to be exceeded if the excess is only exceptional and temporary and the ratio of the government deficit to GDP remains close to the reference value. Pursuant to Article 104 (3) of the EC Treaty, the Commission, in its report on initiating an excessive debt procedure, is required to consider the ratio of the deficit to public investment, the medium-term economic and budgetary position of the member state as well as "all other relevant factors".

Exceptional economic circumstances

In contrast to the earlier arrangement, exceptional economic circumstances are now already constituted by a negative growth rate

Current and future provisions of the Stability and Growth Pact

Item	Current provisions	Future provisions
Medium-term budgetary objective		
Definition	Budgetary position close to balance or in surplus Note: owing to measuring uncertainties, deviations of up to 0.5% of GDP are acceptable.	Country-specific objectives ranging between -1% of GDP (given high growth rates and low levels of debt) and a budgetary position close to balance or in surplus.
Deviations	None	Deviations in the case of certain structural reforms.
Adjustment path to medium-term budgetary objective	Not governed by the Pact; self-commitment of the Council.	Budgetary consolidation of 0.5% of GDP if the medium-term objective is not achieved. Greater consolidation in “good times” and less consolidation in “bad times”. Deviations in the case of certain structural reforms. No sanctions if consolidation is not achieved.
Justification for overshooting the 3% reference value		
Exceptional and temporary influences	– Natural disasters – GDP decline of at least 2% – GDP decline of between 0.75% and 2% per year at the Council’s discretion	– Natural disasters – Negative growth rates – Growth rates below potential growth with considerable accumulated loss of output
Other factors	None	– Development of potential growth – Prevailing cyclical conditions – Implementation of the Lisbon strategy – Expenditure on research, development and innovation – Earlier budgetary consolidation in “good times” – Sustainability of debt level – Public investment – Quality of public finances – Burdens resulting from financial contributions to fostering international solidarity – Burdens arising from achieving of European policy objectives, notably the process of European unification – Pension reform
Deadlines for correcting deficit	The year after the deficit is identified unless “special circumstances” exist. Note – “Special circumstances” not defined. – After giving notice, the Council is free to decide on the deadline for deficit corrections.	Generally, the year after the deficit is identified. Given “special circumstances”, which are defined by way of “other factors”, two years after the deficit is identified. Note – After giving notice, the Council is still free to decide on the deadlines for deficit corrections.
Deadlines under the excessive deficit procedure		
Identification of an excessive deficit	Three months after semi-annual budgetary report	Four months after semi-annual budgetary report
Taking effective measures	Four months	Six months
Giving notice after identifying insufficient measures	One month	Two months
Taking effective measures after being given notice	Two months	Four months
Revisions of the correction deadlines	None	In the event of “unexpected events”, repeat of the first recommendations for correcting the deficit and of the recommendations when giving notice.

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or a considerable accumulated loss of output during periods of below-average growth.

Other relevant factors

For the Commission's report on initiating the excessive deficit procedure and for the subsequent Council decisions, "other relevant factors" are potential growth, the prevailing economic conditions, the implementation of measures in the context of the Lisbon Strategy, and measures to promote research and development as well as innovation, efforts at budgetary consolidation in "good times", the sustainability of the level of debt, public investment and the "quality of public finances". Moreover, due account is to be taken of other objections by the deficit country concerned given, say, strains resulting from "financial contributions to fostering international solidarity" and "to achieving European policy goals, notably the unification of Europe".

Taking account of systemic pension reforms

Pension reforms introducing a multi-pillar system that includes a mandatory, fully funded pillar are to be taken into account in the Commission's and Council's considerations. When assessing under Article 104 (12) of the EC Treaty whether the excessive deficit has been corrected, the Council will also take into consideration the net cost of the reform to the publicly managed pillar. The percentage of the costs to be considered will be reduced in stages over a period of five years from 100% to 20%.

Reducing the debt level

The Council is to make a qualitative assessment of the reduction of high debt ratios and may issue recommendations.

Extension of deadlines

The deadline for the Council to establish the existence of an excessive deficit under Article 104 (6) of the EC Treaty is being extended to four months following the half-yearly fiscal notification. In future, the member states will be given six months to demonstrate that effective measures have been taken to correct the deficit. Furthermore, the deadlines between the Council's decisions under Article 104 (8) of the EC Treaty, ie establishing that no effective action has been taken and deciding to make its recommendations on correcting the deficit public, and the Council's decision pursuant to Article 104 (9) of the EC Treaty to give notice to the member state failing to put the recommendations into practice to take remedial measures, are to be extended to two months. In future, the member state in question will have four months to demonstrate that effective measures have been taken after being given notice pursuant to Article 104 (9).

Initial deadline for correcting the excessive deficit

In case of "special circumstances", the deadline for correcting the deficit may be extended to two years following its identification. The decision as to whether special circumstances exist will include an assessment of the "other relevant factors" pursuant to Article 104 (3) of the EC Treaty.

Repeat procedures

In the event of unexpected adverse economic events during the current excessive deficit procedure, the recommendations under Article 104 (7) of the EC Treaty, ie the first recommendation on correcting the deficit, and the recommendations associated with giving notice pursuant to Article 104 (9) of the EC Treaty, may be repeated and reformulated

if the member state concerned has implemented the earlier recommendations but the deficit has nevertheless not been corrected.

Assessment of the envisaged changes

Budgetary discipline and Lisbon Strategy

In connection with the proposals to amend the Stability and Growth Pact, the European Council referred to its Declaration on Article III-184 which is annexed to the future European Constitution. The declaration itself establishes a link between the Lisbon Strategy of raising potential growth and the amendment of the Stability and Growth Pact: in phases of weak economic growth, budgetary policies are to set the key priorities for promoting reforms, innovation, competitiveness and investment as well as consumption. This is to be reflected in the framing of budget decisions, with budgetary discipline to be safeguarded in accordance with the constitution and the Stability and Growth Pact. Nevertheless, the Deutsche Bundesbank considers that the changes to the pact weaken the commitment to pursue a sound fiscal policy. No binding commitments are required of the member states to consolidate government budgets during an economic upturn or to reduce high levels of debt. There was initially discussion about the instrument, albeit a weak one, of an "early warning" by the Commission in the event of failure to meet the medium-term budgetary objective, as well as the possibility of quantitative requirements for reducing the level of debt. However, these proved to be incapable of gaining acceptance.

Differentiation among countries poses problems in a monetary union

Our criticism of the proposed changes to the pact starts with the idea of taking account of country-specific circumstances. Not least among the stated reasons for this is the heterogeneity of the Community following the recent EU enlargement, for which the principle of "one rule for all the member states" is said to be no longer appropriate. This argument could make it easier for the new member states to qualify for introducing the euro. A single monetary policy is predicated on the member states accepting the rules of the Community and being in a position to obey those rules. For that reason, legal and economic convergence are examined as criteria for accession. It should by no means be the case that the well-founded rules for safeguarding sound finances be modified to accommodate a lack of readiness or ability to integrate on the part of individual states.

Relaxing budgetary discipline increases risk of exceeding the reference value

Hitherto, the rules of the Stability and Growth Pact have stipulated that budget positions in the EU member states must be close to balance or in surplus in the medium term, ie over the economic cycle. In this connection, there was a consensus that "close to balance" was to be understood as a deficit of no more than 0.5% of GDP. Now, medium-term deficit targets of up to 1% of GDP are envisaged. In itself, this represents a considerable relaxation of the commitment to budgetary discipline. Added to this is the possibility of deviating from the targets in order to finance reforms. The implication of this is that the budget positions of the member states will edge closer to the 3% reference value. However, this means there will be a growing risk of overstepping the reference value in a

cyclical downturn. The reduction of the debt ratios, too, could be considerably delayed.

Budgetary discipline becomes a moving target

Moreover, country-specific provisions also make the rules more complex and will result in increasing scope for discretion in their application. Budgetary surveillance will be less transparent and the enforceability of the provisions weakened. This will be all the more the case since the possibility of making adjustments to the objectives means that budgetary discipline will become a "moving target".

Relaxation of the deficit limit

Above all, it is the envisaged changes to the excessive deficit procedure that will play a part in making the fiscal framework considerably weaker, more complicated and less transparent. As "economic weakness" in itself will be deemed to be an exceptional circumstance in future and a large number of "other relevant factors" will be introduced, the scope for discretion available to the Commission and the Council when assessing the deficit will be significantly expanded. A further aggravating factor is that the treaty specification that the deficit must be "close to the reference value" when permitting deficit overruns has not been quantified. The 3% reference value as the maximum figure for the annual government budget deficit is thus de facto called into question, and an excessive deficit procedure is likely to be initiated by the Commission and the Council only in cases where the limit has been overshot by a very large margin. This is all the more worrying as the decline in trend growth in the major EU economies – given the implications for the development of the debt ratios – should actually suggest tightening the reference value.

Reduction of adjustment pressure

A large number of possible reasons for justifying higher deficits – which, moreover, may be advanced by the member states themselves – and longer deadlines for correcting deficits will ease adjustment pressure on the deficit countries and weaken their readiness to conduct sound fiscal policies. Moreover, the possibility of ending initiated excessive deficit procedures by referring to the costs of pension reforms will make an early introduction of the euro easier for a number of new EU member states since the requirement of fiscal convergence will be satisfied if no excessive deficit procedure has been initiated.

Special treatment of expenditure categories cannot be justified

An argument against any special treatment of particular expenditure categories in the excessive deficit procedure or in setting medium-term budgetary goals is that debt-financing is per se not justified for most of these categories – nor indeed for any other types of expenditure. Added to this are problems of definition and assessment. For example, government investment and structural reforms are difficult to define and/or categorise and to assess in terms of their impact. This means that the risk of manipulations cannot be discounted. Forgoing debt financing does not, however, present an obstacle to far-reaching structural reforms and does not lessen the positive impact of government measures.

Open-ended scope for interpretation in justifying high deficits

The introduction of "other relevant factors", such as the "quality of public finances" and "financial contributions to fostering international solidarity and European policy goals"

creates additional, open-ended scope for interpretation in justifying deficits above the reference value. In the case of Germany, the current net payments to the EU budget and the costs of unification will be eligible for consideration in future when assessing the deficit. This, too, is not justified from an economic point of view. For example, a debt financing of these net payments to the Community budget, which ultimately benefit other EU countries, would mean shifting the financing of current payments to future generations in the net payer country. This applies equally to offsetting spending on German unification, which largely consists of consumption transfers.

Conclusion

The new rules weaken the pact

In the Bundesbank's view, the new rules severely weaken the Stability and Growth Pact. They diminish both the incentives to pursue a sound budgetary policy and the binding impact of the rules and also send the wrong signals to those countries, which have not yet introduced the single currency. By differentiating among countries, the pact will become less transparent, more complex and, therefore, ultimately even more difficult to enforce.

Relaxing the deficit limit will jeopardise long-term sustainability

The Bundesbank is especially concerned by the decision to relax the general government deficit ceiling of 3% of GDP by modifying the excessive deficit procedure. Severe budgetary problems already exist in many countries of the EU. These are partly due to the fact that the requirements of the Stability and Growth Pact have not always been observed appropriately in the past. The changes which have now been adopted do not solve this problem of implementation. The goals of symmetric budget management over the business cycle and a reduction of high debt ratios are not anchored credibly in the new rules. On the contrary, there is a risk that budget deficits and debt ratios will increase further in the medium to long term.

Poorer underlying conditions for monetary policy

Adapting the budgetary rules to a looser fiscal regime is therefore the wrong course to have taken. As the Bundesbank sees it, it is an especially serious matter that the underlying conditions for the single monetary policy may deteriorate and that conflicts with fiscal policy will become more likely. The European Commission, the Council and the member states should now be aware of their responsibility for the Community and apply the rules in a manner that achieves and safeguards the goal of attaining structurally balanced budgets in the medium term.