

## **The EU Stability Pact and the Case for European Monetary Union \***

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## 1. Introduction

Along with other prospective EMU members, the Irish government is now committed to the “Stability and Growth Pact”, which proposes heavy penalties for countries whose deficit-to-GDP ratios breach certain stipulated conditions. Agreement on the broad outlines of the Pact at the Dublin Summit of 13-14 December 1996 was hailed as a triumph of Irish diplomacy: “Irish Role Praised as Summit Deal is Reached on EMU” was the *Irish Times* lead headline on 14 December, an assessment endorsed by *The Economist* the following week. But most (though not all) academic economists have expressed grave misgivings about the Pact, even those who are pro-EMU. (Wyplosz (1997) is a representative example.) In this paper I want to explain why I believe the majority is right and why the Pact strengthens the argument for postponing Irish entry to EMU until the UK also joins.<sup>1</sup>

## 2. How will the Stability Pact Operate?<sup>2</sup>

The origins of the Stability and Growth Pact lie in the deficit requirement of the Maastricht Treaty. This set a 3% deficit-to-GDP ratio as one of the entry criteria for EMU and also stipulated that an “excessive deficit procedure” would be imposed to police fiscal extravagance after membership. Negotiations on the precise form that procedure would take began in earnest in November 1995 when German finance minister Theo Waigel proposed the imposition of automatic sanctions for countries with excessive deficits. This met with opposition from many other countries and the German proposals were somewhat watered down in Dublin, with the final legal text adopted at the Amsterdam Summit on 16 June 1997.<sup>3</sup>

Figure 1 illustrates the penalty schedule of the Pact as finally agreed. Deficit-to-GDP ratios greater than 3% are deemed to be excessive and, except in specified cases to be discussed below, oblige the offending country to make a non-interest bearing deposit to the Commission. In the first year after a deficit is declared

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<sup>1</sup> For convenience I use “Irish “ and “Ireland” throughout to refer to the Republic of Ireland.

<sup>2</sup> Artis and Winkler (1997) give useful details on the Pact and also reproduce key excerpts from some of the official documents.

<sup>3</sup> Other changes were also made to meet French objections. The term “Growth” was added to the original “Stability Pact” title in Dublin and a separate “Resolution on

excessive, the deposit equals a fixed component of 0.2% of GDP and a variable component equal to an extra 0.1% of GDP for every percentage point by which the deficit exceeds 3%, subject to an upper limit of 0.5% of GDP. In subsequent years the fixed component does not apply but the upper limit is the same (so the maximum penalty is incurred when the deficit reaches 8% of GDP, rather than 6%). Finally, after two years any deposit is converted into a fine if the deficit has not been corrected.

These penalties are clearly draconian. However, they can be waived in specified circumstances, the details of which were the topic of the late-night arguments at Dublin. Figure 2 illustrates. The first let-out is automatic provided the deficit is both “exceptional” and “temporary”. “Exceptional” is defined as either “resulting from an unusual event outside the control of the Member State concerned and which has a major impact on the financial position of the general government” or as resulting from a “severe economic downturn”, meaning an annual fall of 2% in real GDP. “Temporary” means that the Commission’s forecasts indicate that the deficit will fall below 3% following the unusual event or severe economic downturn. Secondly, member states which suffer annual falls of GDP of less than 2% may put their case to the Council for an exemption, but only if they are in “severe” recession, defined as an annual fall in real GDP of at least 0.75%. This latter option, which formed the basis for the Dublin compromise, introduces a discretionary element into the operation of the Pact.

Midnight wrangles over decimal points may make for exciting media coverage but the exact details of the exemptions turn out to be largely irrelevant if past history is any guide. Figure 3 shows the relationship between GDP growth and the deficit-to-GDP ratio for Ireland from 1975 to 1997, in the same space as Figure 2.<sup>4</sup> The picture tells a familiar story: more than a decade of fiscal profligacy, with deteriorating economic performance, followed by a dramatic improvement in both measures from about 1987 onwards. For the present I want to highlight a different aspect of the Figure. Over the whole period, GDP fell in only one year (1983) and then by only

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Growth and Employment” was adopted at Amsterdam. These changes seem largely cosmetic.

0.2%, far short of the 0.75% threshold for potential exemptions. Our bleak years, awful though they were, never corresponded to a “severe” recession, never mind an “exceptional” deficit. In other words, we would have been liable for the full sanction of the Stability Pact, a deposit subsequently converted into a fine of 0.5% of GDP, in every year (apart from 1977) from 1975 to 1985. Straightforward calculations, given in Table 1, show that this would have cost us in total 3.73% of GDP, or a cool IR£1.029 billion, in 1990 prices. It goes without saying that, if the Stability Pact had been in force, the history of those years would have been very different.

The same story is repeated for the whole of the EU. Between 1970 and 1996 the current fifteen member states had year-on-year falls in GDP of more than 2% in only 9 cases and falls between 0.75% and 2% in only 21 cases: a total of less than 8% of all possible cases.<sup>5</sup> It seems safe to conclude that the formal exemptions are likely to apply very rarely.

It is possible to argue, as do Artis and Winkler (1997), that the Stability Pact will not work in practice quite as harshly as the rules might suggest. First, the formal documents are sprinkled with the phrase “as a rule”, which sounds like an invitation to plead special circumstances not already specified in the Pact. Second, a significant amount of time (at least fifteen months) must elapse before even the deposit penalty is actually imposed, especially if a country initially pays lip service to Council recommendations. Finally, the actual decisions on all contested issues are taken by the Council and there could be plenty of scope for horse-trading. Curiously, while the imposition of sanctions requires a qualified majority of EMU members excluding the country in question, the prior decision on whether an excessive deficit exists at all requires a qualified majority of *all* EU members, including the offending country *and* EMU outsiders. Especially if a group of countries was in breach of the 3% limit, it seems likely that they could form a blocking minority to provide mutual exemption from sanctions.

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<sup>4</sup> The data underlying Figures 3 and 4 are given in Table 1 and are taken from the *European Economy*, 1997 Second Quarter, Statistical Appendix, Tables 10, 76 and 77. The figures for 1996 and 1997 are Commission estimates.

<sup>5</sup> Figures from OECD data quoted by *The Economist* of 21 December 1996. The 30 potentially exceptional cases amount to only 7.7% of the 390 possible cases (26 years by 15 countries).

These arguments suggest some flexibility in the application of the Stability Pact. However, even if sanctions are never actually imposed, it seems inevitable that governments' behaviour will be significantly affected by the existence of the Pact. The desire to avoid the political costs of trying to avoid the penalties, as much as the penalties themselves, are likely to provide a strong incentive for corrective action to avoid deficits close to or above 3% of GDP. And that of course raises the key question of why we need a Stability Pact in the first place and whether its economic effects are likely to be benign or not.

### **3. Credibility versus Stabilisation**

The economic arguments for and against the Stability Pact echo those that continue to rage about the EMU project as a whole. On the one hand, there are the potential benefits of committing to a credible low-inflation low-deficit regime. On the other hand, there are the potential costs of losing the flexibility afforded by an independent stabilisation policy. Attitudes towards these issues tend to reflect underlying views on the workings of the macroeconomy and on the potential for discretionary intervention; in popular terms, on the relative merits of a more "monetarist" over a more "Keynesian" approach. (In passing, it is worth recalling that, as pointed out by Thom (1997), almost all Irish politicians have adopted a monetarist position as far as EMU is concerned, despite their oft-stated commitment to employment.)

These issues can be put more concretely by referring back to Figure 3. On the one hand, if a Stability Pact had been in operation, perhaps no Irish government would have allowed the deficit-to-GDP ratio to build up to the levels it had already reached by the mid 1970's. On the other hand, constrained by the Stability Pact and shackled by the debts incurred by their predecessors, new Irish governments in 1977, 1979 or 1982 would have been precluded from acting as they saw fit to expand employment or to counteract external shocks. That might have been appropriate in those instances. But are we sure we want to restrict our freedom of manoeuvre on all future occasions?

The growing academic literature on the Stability Pact contains a number of examples of credibility-type arguments in its favour. Beetsma and Uhlig (1997) emphasise its potential role in restraining deficit-prone governments. McKinnon (1997) sees it as a device for enforcing the collective fiscal retrenchment made

necessary by the buildup of debt and unfunded social security commitments of many continental European countries. Artis and Winkler (1997) view it as a means of avoiding an imbalance between fiscal and monetary policy which might threaten the credibility of the European Central Bank (ECB).

The difficulty with all of these arguments is that they see the ECB as lacking sufficient credibility on its own. But as Dornbusch (1997) emphasises, the Maastricht Treaty stipulates that the ECB will be operationally independent and subject to a “no-bail-out” clause (prohibiting it from financing national debts). Provided these provisions are allowed to take effect, the Stability Pact is redundant. A corollary, noted by Dornbusch, is that heavily indebted countries will be penalised by the markets. Contrary to the view that EMU will equalise the yields on the national debts of all member countries, persistent differentials will emerge, just as they do between the debts of local authorities in federal systems (such as U.S. states and Canadian provinces). Of course, this in turn will make it all the harder for countries which the markets deem to be heavily indebted (hopefully not including Ireland) to abide by the Stability Pact.

Accepting that the role of the Stability Pact in enhancing credibility may be redundant, could it not also be said that constraints on fiscal policy do no harm in themselves, given the limited scope for any one country to gain from exercising it?<sup>6</sup> This may be true to the extent that fiscal policy is thought of only in terms of discretionary changes in the time paths of government spending or tax rates. However, a crucial issue, which goes to the heart of the debate over the Stability Pact, concerns the non-discretionary component of fiscal policy, the so-called built-in stabilisers.

As every student of the Irish economy knows, a boom raises tax revenues and lowers transfer payments. As a result the deficit automatically falls which in turn tends to moderate the boom. As far as the Stability Pact is concerned, the problem is with the converse: a slow-down in the economy automatically worsens the deficit. Rather than reflecting fiscal mismanagement this response should be seen as a

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<sup>6</sup> I leave aside the well-known Mundell-Fleming result that fiscal policy is more effective under fixed exchange rates. (For a non-technical exposition, see *The Economist*, 20 September 1997, Survey on The World Economy, p. 39.) This is

welcome stabilising factor. It is precisely this mechanism of adjustment which will be precluded by the Pact. Governments whose deficits are already close to the 3% limit will find themselves forced to contract just when the economy is turning down. This procyclical fiscal policy will definitely lead to instability by increasing the variance of the cycle and it will probably reduce growth by accentuating irreversible firm closures: exactly the opposite of the Pact's eponymous objectives. Of course, it is precisely to counter this effect that the 0.75% and 2% exemption thresholds were included in the Pact but as I have already argued these are unlikely to apply except in extreme downturns.

How important is this effect likely to be in practice? Very important, according to Eichengreen (1997), who quotes research by Bayoumi and himself suggesting that the Pact could increase the magnitude of output fluctuations in Europe by 20%. Buti et al. (1997) are more optimistic. They estimate that the cyclical component of most EU countries' budgets (including Ireland's) varies on average by one percentage point of GDP around its mean and conclude that member states should easily meet the constraints of the Pact provided their budgets are initially balanced. But, as even they admit, this is precisely the problem. In a situation where most countries will enter EMU with already large deficit-to-GDP ratios, their room for manoeuvre in response to negative shocks will be very limited. This applies all the more so to Ireland, where in the strongest boom in our history we are still running a deficit (or a small surplus according to more recent data than that in Table 1). It is clear that to avoid ever breaching the 3% threshold it is necessary to balance the budget on average, with a large surplus in booms. There seems little prospect that future Budgets will move in that direction, any more than recent ones have to date.

Note a link between the two arguments that I have given. The size of initial debt stocks may make some sort of Stability Pact more desirable as a means of ensuring the credibility of monetary policy. However, the size of initial deficits makes the Pact a much greater constraint on national budgets. Given that the prospects for a

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unlikely to matter for Ireland, though it may well be important for some of the larger European countries.

system of income-smoothing transfers from Brussels are remote,<sup>7</sup> the bulk of adjustment to shocks will fall on domestic wages and prices.

Given its importance, there is regrettably little systematic research on the magnitude of built-in stabilisers in the Irish economy.<sup>8</sup> To examine this issue it is not enough to look at the budget deficit. It is the appropriate concept when we are concerned with long-run solvency or with meeting the requirements of the Stability Pact. However, it is not appropriate when we wish to evaluate the stance of fiscal policy. For this we need first to net out interest payments since they are determined independently of domestic conditions by past borrowing and current interest rates. Figure 4 shows Irish GDP growth rates relative to the ratio of the primary budget deficit (i.e., excluding interest payments) to GDP. This picture is clearly very different from Figure 3. (The difference peaked in 1985, when we paid a colossal 9.7% of GDP in interest payments.) Unfortunately, without a lot more research there is no way of deciding how much of the movement in Figure 4 is automatic and how much reflects discretionary changes in fiscal policy. However, it seems safe to conclude that cyclical factors contribute on average at least one and maybe as many as three percentage points to movements in the deficit-to-GDP ratio, making us vulnerable to breaches of the Stability Pact threshold whenever the current boom ends.<sup>9</sup>

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<sup>7</sup> On this point I agree with Artis and Winkler (1997) and Wyplosz (1997) rather than Eichengreen (1997, pp. 11-12).

<sup>8</sup> Lane (1997) is an interesting recent exception. He emphasises the political incentives for procyclical fiscal policy but models discretionary fiscal policy as a once-off intercept adjustment in 1987. Further work on this topic is clearly needed.

<sup>9</sup> On a technical note, I am sceptical of estimates of the relationship between the deficit and GDP which use the data in Figure 4 alone. (Variants of this method are used by Buti et al. (1997), Eichengreen (1997), Lane (1997) and Thom (1997).) Regressing the primary deficit-to-GDP ratio (D) on GDP growth (Y) for the whole sample gives:  $D=2.63-0.57Y$ ,  $r^2=0.13$ . This suggests plausibly that a one percentage point increase in GDP growth worsens the primary deficit by 0.57% of GDP. However, the relationship disappears when the sample is split. Estimates for 1975-1986 are  $D=3.01+0.15Y$ ,  $r^2=0.03$ ; and for 1987-1997 are  $D=-4.34+0.08Y$ ,  $r^2=0.02$ . A period with such dramatic changes in the discretionary component of fiscal policy cries out for structural techniques to estimate the non-discretionary component.

#### **4. EMU and Ireland: Chronicle of a Debacle Foretold**

I have suggested that the Stability Pact is bad for all future EMU participants. Is it especially worse for Ireland than for others? Our more favourable debt and deficit performance puts us in a stronger initial position than many other founding members. On the other hand, our greater exposure to asymmetric shocks, especially with the UK outside EMU, means that constraints on fiscal policy may be even more serious for us. This alone would be a reason for us to reconsider entry if we had a reasonable alternative. As I and many others have argued before, we do have such an option (assuming that the UK does not enter in 1999) and there are many other reasons for adopting it. The issues are sufficiently important to merit repetition, so before concluding I want to recall and update the arguments (drawing on Neary (1997) and Neary and Thom (1997)).

**Cost-competitiveness is crucial:** No one disputes this, especially when national wage agreements are being concluded. But the nominal exchange rate is the determinant of competitiveness over which we have most control in the short run (despite which the text of Partnership 2000 makes no explicit allowance for wage moderation contingent on exchange rate changes). The claim that EMU membership will by itself reform our labour-market institutions is untested and implausible. Ten years of Thatcherism did not prevent the UK from entering the EMS at an over-valued exchange rate and being punished accordingly.

**Our bilateral exchange rate with Sterling is crucial:** The commodity composition of our exports suggests that our sales to the UK are by firms which are disproportionately labour-intensive, Irish-owned and vulnerable to a loss of cost competitiveness. Moreover a focus on exports underestimates our exposure to UK competition. The recent takeover of Quinnsworth by Tesco illustrates that potential competition in the home market comes disproportionately from the UK and that goods often thought of as non-traded are not intrinsically so.

**EMU does not guarantee lower interest rates:** We still sometimes hear the suggestion that post-EMU euro rates will be identical to pre-EMU DM rates. However, I think it is now widely recognised that (like the euro-dollar exchange rate) the level of euro interest rates cannot be predicted with confidence. Whether or not French pressure for a Stability Council with teeth is resisted, the fledgling ECB may

have to work hard to establish its credibility, which could require high interest rates from the beginning.

**Lower interest rates are not necessarily desirable:** Of course we all want low nominal interest rates (which really means low inflation) and no return to crisis real interest rates such as we suffered in late 1992 (which really means a credible exchange-rate policy). But who wants low real interest rates? Borrowers do, of course, but not savers (who get short shrift in Baker et al. (1996)). Nor does the Central Bank, which has been rightly stressing the dangers of over-stimulating an already booming economy for the past year. On welfare grounds, the national gain from lower interest rates depends on our external indebtedness. As Baker et al. (1996) point out, this gain is minor if we (plausibly, for want of a better assumption) assume a given external interest rate. On employment grounds, the argument that lower interest rates will cushion exporters from a sterling depreciation would only be valid if euro interest rates were positively correlated with the sterling-euro exchange rate, a relationship which is no more likely than the opposite.

**We are not legally obliged to join EMU in 1999:** The Maastricht Referendum of 1992 was fought over different issues and in the absence of significant new information (such as the details of the Stability Pact and the salutary reminder in 1992-1993 of the continuing importance of sterling). We will not strictly meet the debt requirement and will need to plead that the ratio is falling. It is inconceivable that the Council would try to insist on our joining if we chose to resist it. There have even been press reports suggesting that Germany might be willing to pay us not to join in the first wave! Sweden has already chosen not to join in 1999, despite the fact that it has no opt-out and meets all the criteria except (like us) the debt ratio target and the (arguably moot) requirement to be in the EMS bands for two years; yet there has been no talk of sending tanks to Stockholm. Our politicians cannot waive responsibility by claiming that their hands are irrevocably tied.

**It's not "all politics anyway":** In continental countries this is often taken to mean that EMU is necessary to prevent another land war in Europe. In Ireland it is interpreted to mean that membership is needed to keep us "at the heart of Europe". Both arguments are vulnerable to the slogan of that consummate politician Bill Clinton: "It's the economy, stupid!" If EMU results in a significant deterioration in economic performance it could slow rather than hasten progress towards other goals

such as the deepening of the Single Market, the admission of new members and the reform of EU institutions. (Feldstein (1997) gives a pessimistic trans-Atlantic view.) Arguably, the deflation needed to meet the Maastricht criteria has already done great harm to democratic institutions by boosting the far Right in France. And what better way for Ireland to stay “at the heart of Europe” than to enjoy continuing growth?

**The status quo is a good option:** Opponents of Irish entry without the UK are sometimes accused of wanting a return to a full link with sterling. But tying ourselves to one currency bloc with which we do less than half of our trade makes no more sense than tying ourselves to another. In a situation where there are unavoidable fluctuations between sterling and continental currencies it surely makes most sense to try and steer a middle course. One way of doing so would be an explicit trade-weighted real exchange-rate target. Even better might be a rough form of inflation targeting which adjusted interest rates to maintain approximate stability of the true price level (allowing for a 1 or 2% overestimate by the CPI). This too would lead to an exchange rate roughly average of that with our two main trading partners. If this sounds familiar, it is because it is a good description of the policy which the Central Bank has in effect been following since early 1993. It has worked well for us so far. Why not continue with it through what seems likely to be a turbulent period for the sterling-DM and then sterling-euro exchange rates? It is never too late to do the right thing.

## 5. Conclusion

With almost all Irish politicians strongly in favour of EMU entry, debates on the pros and cons of Ireland’s membership are dismissed in some quarters as out-of-date. This attitude was vividly summarised at last year’s Kenmare conference by Brendan Dowling, who described arguments about EMU as no more useful than “studying the bolts on Shergar’s stable”. I prefer a different image: such debates are important and timely because they call attention to the contours and crevasses of the icebergs towards which we are now blithely steaming.

Lest I be accused of scaremongering, let me explain that EMU itself is not one of the icebergs. They will be there whether we join or not. They include some perils of which we are aware (the risks of prolonged Sterling-EMU misalignment; the lack of synchronisation between Irish and continental business cycles) as well as some

which we have not yet imagined. (Who in 1972 forecast a quadrupling of world oil prices? Who in 1988 forecast German reunification?) Rather, joining EMU means throwing overboard the rusty, over-used but still serviceable lifeboat of nominal exchange-rate adjustment. The Stability Pact compounds this error by throwing a second lifeboat overboard, constraining our fiscal policy and in particular emasculating our automatic stabilisers. Losing these policy instruments throws all the burden of adjustment onto domestic wages and prices, with consequences for which we are totally unprepared. In the words of Yves-Thibault de Silguy, the commissioner in charge of the euro, “people who hope that the euro means the end of Thatcherism in Europe have got it precisely backwards”.<sup>10</sup>

Of course it is possible that this pessimistic scenario may never materialise. Sterling may cease to diverge from the continental currencies and, before too long, may become a full EMU member. Inflationary pressures in Ireland may remain dormant and the recovery in continental Europe may begin to show up in falling unemployment. Finally, the Stability Pact may do nothing to increase instability or discourage growth, either because it is never invoked or because economic upturn, lower interest rates and cautious policies bring all member countries’ deficits below the 3% threshold. In such happy circumstances Europhiles like myself (note the capital “E”) will rejoice and the only casualty will be the self-esteem of a few academic economists.<sup>11</sup> But the risks of other outcomes are enormous. It is surely extraordinary that Irish politicians are so near-unanimous in ignoring such risks and in embracing EMU and the Stability Pact with such enthusiasm.

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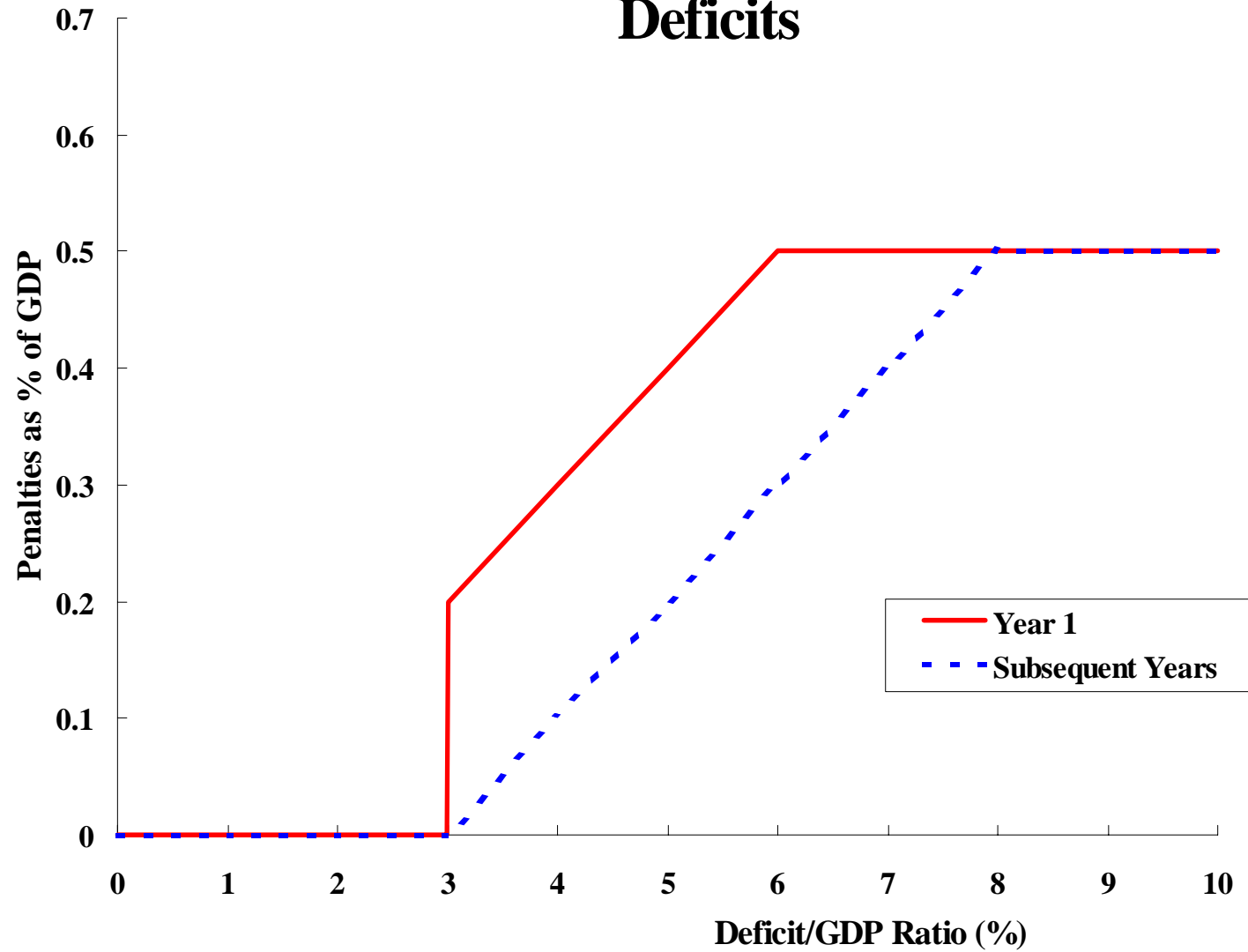
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<sup>10</sup> Quoted in *The Economist*, 11 October 1997.

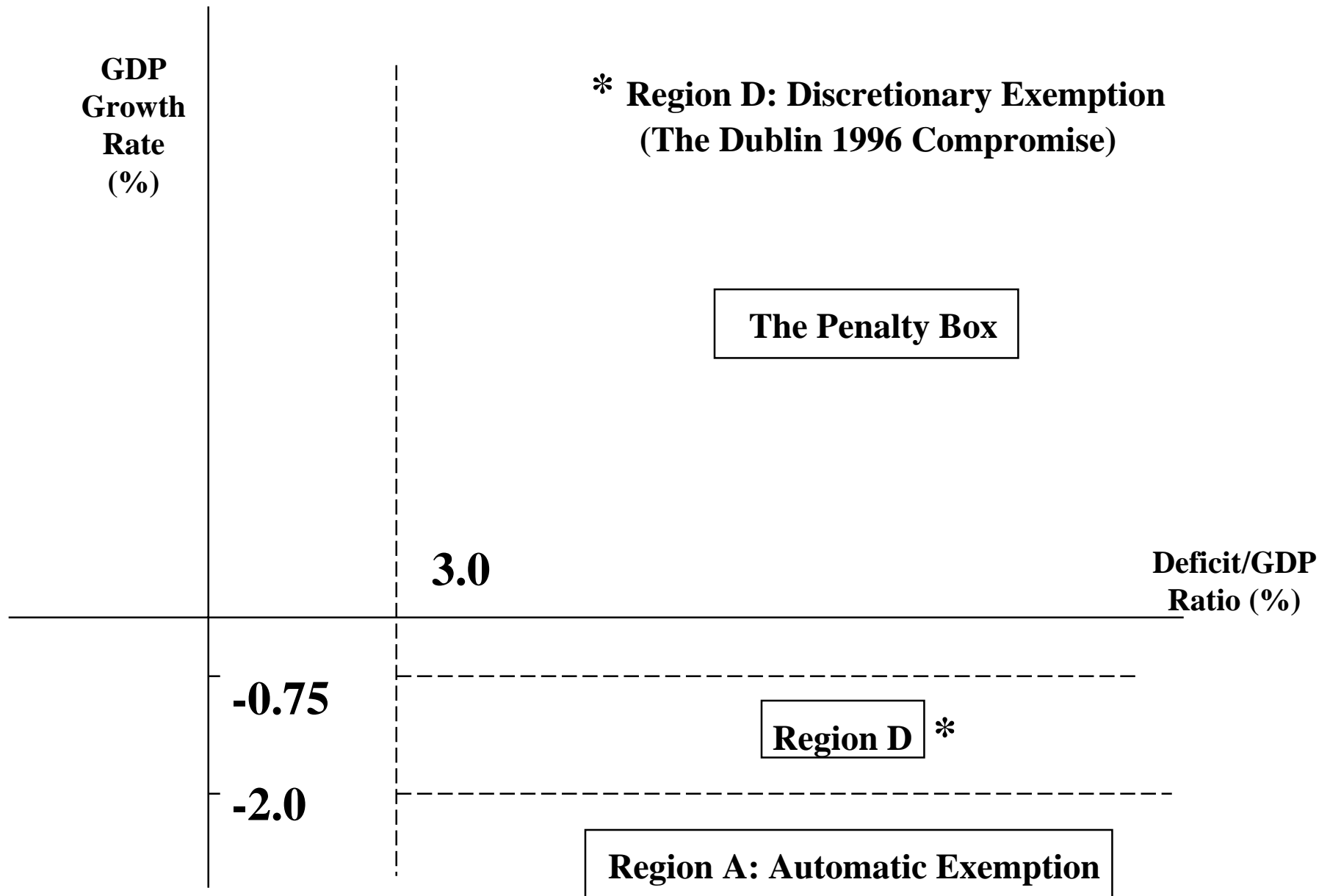
<sup>11</sup> Quite a few actually. Contrary to suggestions made by Ruairi Quinn while he was Minister for Finance, to my knowledge every university economist who has commented on the matter has expressed grave reservations about our joining EMU if sterling does not.

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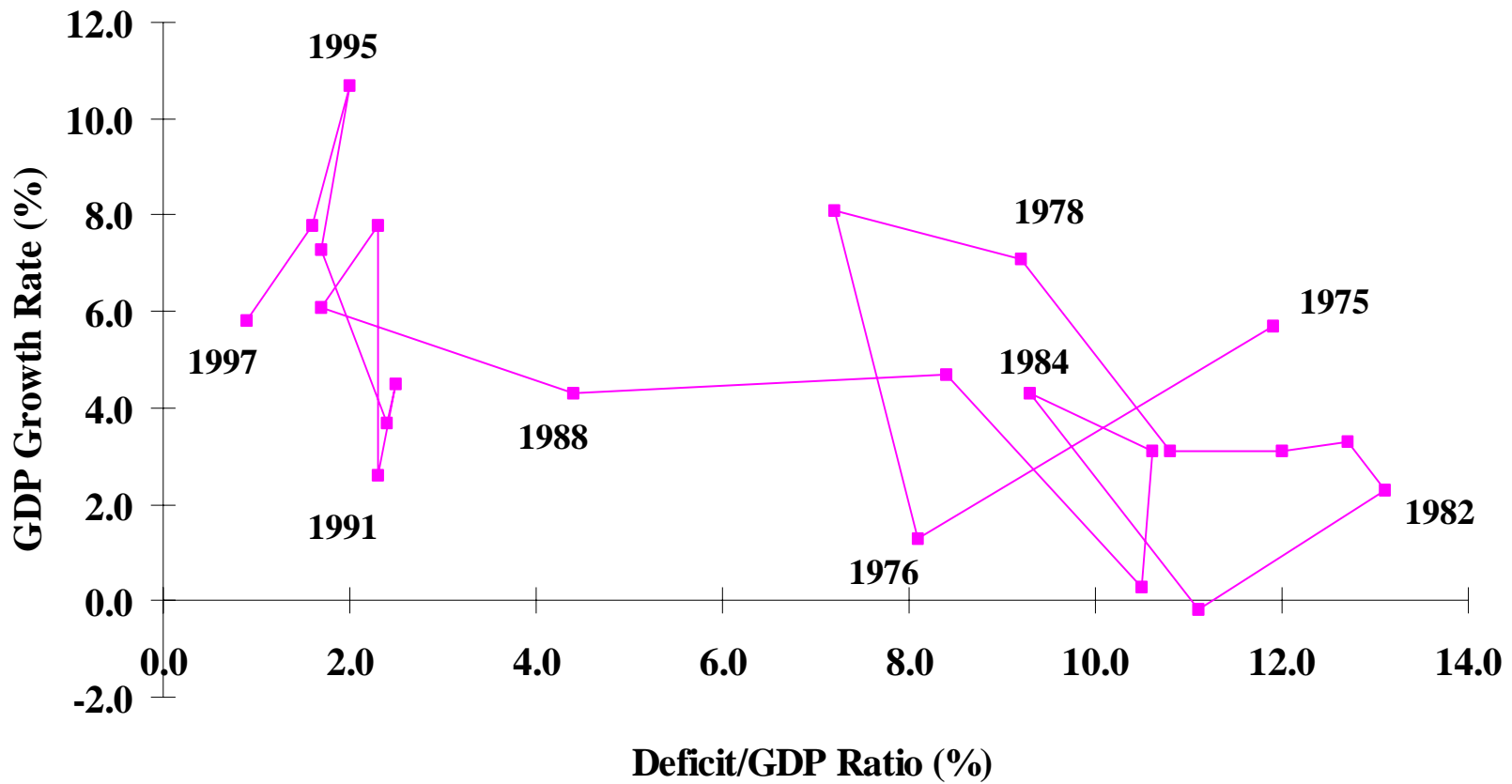
**Fig. 1: Stability Pact Penalties for Excessive Deficits**



# Fig. 2: Exemptions from Stability Pact Penalties



**Fig. 3: GDP Growth and the Deficit/GDP Ratio, 1975-1997**



**Fig. 4: GDP Growth and the Primary Deficit/GDP Ratio, 1975-1997**

