What Remains of the Stability Pact and What Next?

Lars Calmfors, IIES Stockholm

Summary of Bruegel-Sieps lunchtalk 6 December 2005

N.B. This report has not been submitted for approval to the speakers, who therefore bear no responsibility for it. It is intended for the sole use of Bruegel's staff and members and should not be circulated to third parties.

The Stability and Growth Pact has "more or less collapsed" as a result of the reforms, leading Swedish economist Lars Calmfors told at a lunchtime meeting at Bruegel. Presenting a report on the pact, prepared on behalf of the Swedish Institute for European Policy Studies (Sieps), he was strongly critical of the loopholes introduced for governments reluctant to act decisively to reduce excessive deficits.

"Rules that are not clearly defined or which are open to interpretation from time to time can never command legitimacy", he said. Instead, they were likely to change in response to violations – at least if the perpetrators were large countries.

Countries with large deficits now had the possibility of extending the deadlines for compliance by putting forward a range of "excuses" including claiming to be following policies in support of the Lisbon agenda, and fostering the goals of innovation and European unification. This meant that under certain circumstances it could take up to 9 years for sanctions to be imposed compared with three years under the original pact.

What next?

Looking forward, Calmfors said strict and effective application of the new stability pact was needed but unlikely. Looking at the extended deadlines given to Italy and Portugal, and the expected extensions in 2007 for France and Germany, he said that a lax precedent had already been set. Therefore, additional efforts to induce fiscal restraint would be required.

Possible recipes for restoring credibility included:

- moving decisions to sanction countries to the European Court;
- excluding badly behaving countries from voting in the excessive deficit procedures taken against others:
- enhanced co-operation among fiscally disciplined countries, particularly among the smaller EU members, who had typically been more disciplined than the larger ones.

However, Calmfors remained ultimately sceptical of international efforts to help combat excessive fiscal deficits due to flaws in the political process and therefore called for efforts at the national level. He proposed the setting up of national fiscal policy councils made up of independent experts, who would act as guardians of the fiscal policy objectives determined by their national parliaments.

Rules or "discretion"?

Responding to the report, André Sapir said that even the original stability pact had failed to restrain countries from running deficits during relatively good economic periods.

The criticism of the fuzziness in the new rules, and the point that they could be adapted when large countries had problems, was justified. However, the original pact would probably not have experienced its problems if Germany's position had been different in

2003. The German Finance Minister had wanted to respect the pact, but had been overruled by the Chancellor in the run-up to an election campaign. Similar factors had applied in France, where the process of adjustment was halted from above.

Looking at the problems of the last five years, he concluded that some discretion was good, but this discretion needed to be managed. He advocated the creation of a “credible” European institution that would decide on the discretionary management. One possible candidate was a network of fiscal authorities made up of both national and European partners. At the EU level, DG Economy and Finance could potentially play a part, provided it was seen as acting independently, much like DG Competition. The ECB was another possibility.

Viewpoints
In the general discussion, opinion was divided on the question of whether or not more discretion in the application of the pact was a good or bad thing. There was also some support for the idea of smaller countries cooperating to ensure a vigorous implementation of the rules, possibly forming a coherent voting bloc.

A number of participants commented on the politically unrealistic nature of the proposal to set up national fiscal watchdogs – a point conceded by Calmfors, who said that some politicians had candidly admitted that, having handed over monetary policy to the central bank, they were not prepared to take a hands-off approach to fiscal policy as well.

One contributor asked if the restraining role once played by markets might return at some time in the future. Another said he felt the jury was still out on the new pact but there was cause for “cautious optimism”. Some of the flexibility provisions had already been used to give countries a longer period of adjustment, but the “relevant factors” provision had not been called into play, even by the UK, which might have had some grounds to do so.

Several participants mentioned the IMF’s recent assessment of the eurozone fiscal positions had been largely favourable, and one strongly supported the fact that the pact now involved more interaction with governments, greater consensus, and a sense that everything was not being decided in Brussels.

Lars Calmfors, responding to the idea of a network of fiscal policy authorities managing the stability pact, said that he felt there was a need for the involvement of experts at the national level so that the initiative was not seen as coming from Brussels. At a later point in time, forming such a network might be valuable.

He also accepted the point made by one questioner that the case for setting up national fiscal watchdogs was just as relevant for countries outside the eurozone, who if anything needed to take an even more disciplined approach to fiscal management.

Calmfors said that while the old pact had not been perfect, he expected matters to be even more difficult after the reforms. “Somehow optimists seem to have gathered here in Brussels. I do not meet so many optimists in other places”, he added.