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European public finances under pressure?

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This paper should be read as complementary to my last briefing paper (N°3, September 2001)

The European policy mix

At its meeting on 8 November, the Governing Council of the ECB decided to reduce the minimum bid rate on the main refinancing operations of the Eurosystem by 50 basis points to 3.25%. This decision was welcomed even if it could have been taken earlier, most of the forward looking “informations” on which it was grounded being already available: the slowdown of the expected rates of growth of both output and prices in the Euro area. If we consider current forecasts for inflation (1.8%) and growth (1.5%) in the area for 2002, that means that monetary policy is neutral, putting fiscal policy under pressure. In my last briefing paper, I exposed the reasons why the job of stabilisation should better be left to monetary policy than to *discretionary* fiscal policy. The policy mix adapted to present circumstances should thus imply both an expansionary monetary policy and a neutral fiscal policy, which means that the automatic stabilisers should be left to play their role. With a neutral monetary policy (but may be the ECB will soon take some steps in the good direction), there is a strong incentive for government to use discretionary fiscal policy to remedy to the present slowdown of growth.

This incentive is all the more powerful that the dramatic events of September 11, are clearly calling for non-market governing forces to re-establish confidence. Considering the economic consequences of these events, one may question the credibility of rules – the stability and growth pact – if these rules impose further limitations on sovereignty in Europe. Not only does the pact limit public deficits to 3% of GDP for each country, despite their different initial conditions at the entry in the area, but it constrains governments to commit to medium-term fiscal balance. Under exceptional circumstances – as the ones we undoubtedly are – it is unlikely that these rules if they are obeyed to the letter, will lead to “good” economic policy.

At a time where most economic observers around the world are worrying about growth prospects, and the way and means to avoid a too sharp slowdown of growth or even a recession, Europeans are worrying about headline deficits and the ways and means to constrain governments to obey the stability plans they have designed *before* the slowdown. As already underlined in my last briefing paper, stability plans are conditional on expected growth, and if expectations are wrong, nominal targets embedded in the stability plans will also be wrong. For nominal targets to be respected *à tout prix* stability plans have to be substantially revised.

There is thus a trade-off between the revision of nominal targets for deficits and the revision of fiscal policy itself! If the European strategy is “nominalist”, that is if the revision of fiscal policy is always, or almost always, preferred to the revision of nominal targets the private sector will be exposed to a cumulative uncertainty. An unexpected decrease in the rate of growth will lead to an unexpected change in fiscal policy. One just has to imagine the increase in uncertainty for private agents if discretionary fiscal policy is aimed at compensating the effects of automatic stabilisers to understand the strength of the arguments. Should for example, the level of tax be conditional on the rate of growth ? Procyclical fiscal policy will be the rule whenever a surprise arises. This is exactly the recipe for a destabilising macroeconomic policy. The only justification of such a policy would be an insolvency problem of the type which leads the IMF to advocate a structural adjustment programme to a developing country. But notice that an ingredient of such a programme is always a currency depreciation! There is thus an element of gross exaggeration in the present debate. The focus on headline public deficits serves no purpose but to hidden the absence of governance (political) in Europe. Exceptional circumstances call for exceptions to the rules, i.e. political decisions, and indeed the stability pact itself allows for such exceptions.

A quantitative appraisal

To understand better the reason why the present concern about deficits is exaggerated, a quantitative appraisal is in order. Under present (revised) forecasts, the evolution of public deficits for each country and for the Euro-area as a whole is given in the table below.

An examination of this table helps to make several points. First under present forecasts no member state will be in jeopardy of breaching the 3% deficit barrier. Admittedly Germany will be very near the limit in 2002. But taking into account the most recent informations it is very unlikely that it will breach it, or if it does, that it will do it by a sizeable amount. Only under a very pessimistic scenario will German deficit be significantly higher than 3%. And I imagine that if it where the debate will not be about the size of the deficit but rather about the level of unemployment and the best way to reshuffle the German economy. Consider the following experiment: a country which approaches the 3% limit, say Germany, will be asked if the stability pact is taken to the letter, to postpone the planned decrease in taxes it decided last year. That implies that taxes can be decreased only in “good” years. How can we make sense of such a rule? If growth would have been as expected, nobody would have criticised Germany as its deficit would have been much lower. Hence a procyclical policy is favoured by European “nominalism”. It is because, by luck, the decrease in taxes decided by the German authorities is clearly countercyclical that the issue arose.

Second, the whole Euro area deficit is well below the 3% limit as it will reach 1.4% in 2002 and then decrease. Third, the increase of the Euro area deficit is neatly correlated with the output gap as it should be. That indicates that there is nothing wrong with fiscal policy in Europe. This assessment is strengthened by a look at the evolution of long term interest rates which is clearly more correlated with the rate of growth than with headline deficits.

Net borrowing (-), general government (as a % of GDP)												
	DEU	AUT	BEL	FIN	FRA	GRC	IRE	ITA	NLD	PRT	ESP	EURO
1998	-2,1	-2,4	-1,0	1,3	-2,8	-2,8	2,4	-3,1	-0,7	-2,5	-2,7	-2,1
1999	-1,5	-2,2	-0,7	2,0	-1,8	-2,1	3,1	-2,1	1,0	-2,2	-1,2	-1,3
2000	1,4	-1,7	-0,1	4,2	-1,5	-1,2	6,4	-0,1	1,7	-1,7	-0,3	0,2
2001	-2,5	-0,2	0,0	4,8	-1,5	0,0	2,4	-1,2	1,3	-2,0	0,1	-1,1
2002	-2,7	-0,4	-0,2	2,9	-2,0	0,3	1,8	-1,2	0,5	-1,6	-0,2	-1,4
2003	-2,2	0,4	0,1	2,3	-1,6	0,8	1,8	-0,9	1,4	-1,4	0,0	-1,0
Primary balance, general government (as a % of GDP)												
	DEU	AUT	BEL	FIN	FRA	GRC	IRE	ITA	NLD	PRT	ESP	EURO
1998	1,1	1,4	6,6	3,1	0,5	-2,8	3,4	5,3	3,6	1,3	1,5	2,1
1999	1,7	1,4	6,4	3,6	1,2	-2,1	3,7	5,0	5,0	1,4	2,5	2,6
2000	4,4	1,9	6,5	5,5	1,5	-1,2	6,7	6,6	5,3	1,9	3,4	3,9
2001	0,7	3,2	6,5	7,0	1,7	6,5	4,2	5,0	4,6	1,1	3,3	2,8
2002	0,5	2,9	5,9	5,1	1,2	6,0	3,4	4,6	3,4	1,4	2,9	2,4
2003	1,0	3,6	6,0	4,4	1,5	6,0	3,2	4,7	4,0	1,7	3,0	2,7
Nominal long term interest rates												
	DEU	AUT	BEL	FIN	FRA	GRC	IRE	ITA	NLD	PRT	ESP	EURO
1998	4,58	4,71	4,7	4,79	4,66	8,5	4,75	4,88	4,63	4,89	4,83	4,83
1999	4,5	4,68	4,71	4,72	4,62	6,5	4,77	4,73	4,63	4,78	4,73	4,7
2000	5,38	5,67	5,67	5,67	5,51	6,5	5,61	5,67	5,53	5,75	5,55	5,53
2001	4,8	5	5,1	5	4,9	5,3	4,9	5,2	4,9	5,1	5,1	5
Output gap relative to potential output (as a % of potential output)												
	DEU	AUT	BEL	FIN	FRA	GRC	IRE	ITA	NLD	PRT	ESP	EURO
1998	-1,7	-0,5	-2,1	-2,3	-2,1	-2,2	1,5	-1,8	0,2	0,1	-3,2	-1,8
1999	-1,8	-0,8	-1,7	-1,8	-1,2	-1,7	2,9	-2,3	0,7	0,0	-1,3	-1,4
2000	-0,7	0,3	-0,6	0,1	0,3	-0,8	5,5	-1,6	1,6	0,1	-0,4	-0,3
2001	-0,5	-0,3	0,8	3,0	0,3	2,0	4,0	-0,3	0,3	0,0	0,2	0,1
2002	-1,5	-1,1	-0,3	1,8	-0,6	2,2	-0,2	-0,9	-1,1	-1,5	-0,9	-0,9
2003	-0,5	-0,6	0,3	1,8	-0,4	3,0	-1,8	-0,2	-0,7	-2,0	-0,4	-0,4
Sources: OECD until 2000; EC after (projections of October/November 2001)												

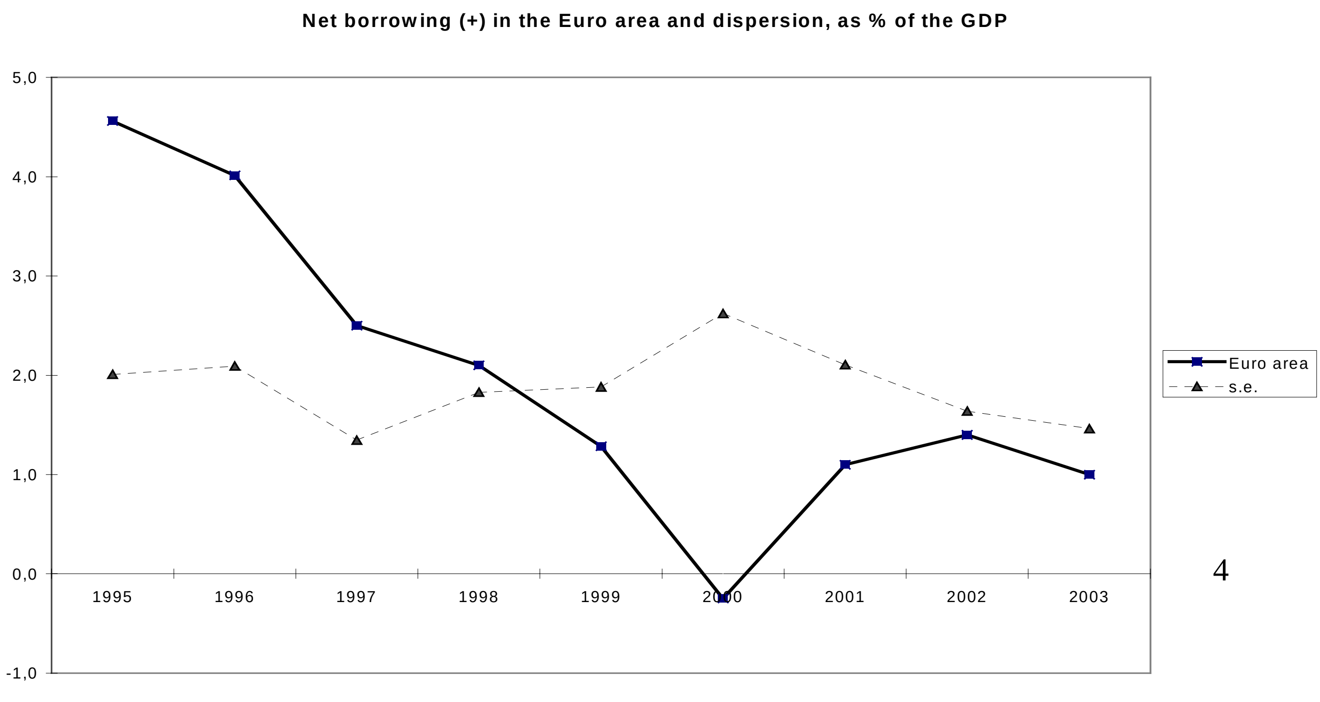
Forth, saying that European public finances are under pressure seems grossly exaggerated, if one considers primary surpluses. All European countries, except Greece, had a primary surplus at least since 1998. Their reductions in 2001 and 2002 at the Euro level will be a transitory phenomenon as they their are reported to increase again as from 2003.

That the medium term objectives of reaching balance in 2002/2004 should be postponed is simply the reflection of the fact that growth rates in 2001 and 2002 are lower than expected when the stability plans have been designed. It does not mean that fiscal policy has to be procyclical now, but rather that it should continue to be countercyclical when growth would resume.

Dispersion of the deficits

The relevance of a norm defined in absolute terms for headline deficits has thus to be questionned. In fact, the level of the norm, be it 1, 6 or the actual 3%, is not the most important drawback of the Pact, although, of course, the smaller it is, the most frequently it will be breached! What is more problematic with the deficit barrier, is that it promotes the a-theoretical idea that national public deficits in a monetary union should converge. The intuition, and most papers on this topic (Fitoussi, 1999; Kenen, 1991) tells the opposite: losing their monetary instrument as well as the exchange rate, policymakers need fiscal policies to offset, at least, short-term shocks.

An increase in the dispersion of public deficits around their Euro area average should not for this reason be considered as bad in itself. No theory implies that the dispersion of public deficits in a monetary union should be constant after a shock. A higher dispersion could occur if a common shock has asymmetric effects. It will in this case be associated with better stabilisation properties. If a common shock has common effects in the whole area, constant dispersion should be expected. What does the data tells us about this?



Graph 1 shows that between 1995 and 2000, public deficits have been considerably reduced in the Euro area, from 4.5% to 0% of GDP. Before 2000, the dispersion of European deficits around their average has been very stable and slightly downward trended. In 2000 however, the dispersion has increased due essentially to the substantial improvement in Finnish and Irish public finances (dispersion is not weight-averaged). Despite gloomy prospects, it is interesting to note that dispersion should be decreasing between 2001 and 2003, although the difference between the highest deficit and surplus should remain substantial.

Conclusion

In the recently agreed and revised "Code of conduct on the format and content of the stability and convergence programs", member states have agreed that "medium-term budgetary positions that respect the close-to-balance-or-in-surplus rule of the SGP must also take account of unforeseen risks and other sources of variability and uncertainty in budgets and the need to ensure a rapid decline in high debt ratios." (European Economy, 73, EC, 2001). Reading it between the lines, such a statement implies, that structural budget deficits should be the relevant concept. It is a clear step towards the good direction. But does the present situation imply the implementation of new tax cut and/or additional spending? I suggested in my last briefing paper, that as most European governments have decided on a pluriannual programme of tax cuts, they should decide to implement the programmes on a shorter time span. The French government has already done something of the sort in increasing *"la prime à l'emploi"*. But it could be worthwhile to announce such a decision in a concerted way between several European governments. Additional spending has also to be implemented anyway for security reasons. Such a measure has to be coordinated at the European level as it is of a common concern and for reasons of efficiency. More should be done if present forecasts of a recovery in the second part of 2002 prove to be wrong.

References

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