
2005-06-03

PRESS RELEASE

The Stability and Growth Pact: an eventful history

(Article published in the Economic Review, second quarter 2005)

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Less than a decade ago the Stability and Growth Pact was welcomed as one of the pillars of the monetary union. Together with the European Central Bank's independence the pact was to provide the necessary guarantees for the stability of the single currency. Gradually, however, attitudes towards the Pact changed with some observers regarding it as too much of a straitjacket. As a result, the Pact came under increasing fire. The criticism prompted a number of reform proposals from both Member States and the European Commission. However, the concerns were often conflicting making it difficult to reach agreement on exactly how the existing regulations should be changed. In the meantime discontent with the Pact rules, which were felt to be too strict, continued and their application started to slide towards interpretations that did not comply with the spirit nor, in certain cases, the letter of the legal provisions constituting the Pact. Consequently, pressure to change the rules kept mounting. Eventually, the debate on the fiscal rules resulted in a political agreement reached in March 2005. This agreement announced certain changes to the Pact, some quite drastic, although these changes still need to be further specified and technically implemented.

This article places the debate about the Pact and the recent reforms in a broader context. First, it puts forward some theoretical considerations in favour of fiscal rules and explains why clear and strictly applied fiscal rules are even more necessary in a monetary union with a fragmented fiscal policy than in other circumstances. With the creation of the Stability and Growth Pact, mainly at the request of Germany and the smaller member states, the institutional architecture of the EMU was enhanced with an instrument that should assure sustained fiscal stability in the Union. It limited the Council's scope for interpretation in the event of inappropriate fiscal developments, attaching greater importance to strict rules and procedures, and it represented an adequate compromise between the various criteria for optimal fiscal rules. The Pact, when applied properly, was flexible enough, for instance, to cushion any normal cyclical fluctuations through the operation of automatic stabilisers.

The article then describes the fiscal developments in the period during which the Pact applied, demonstrating that the application of the Pact was by no means an unqualified success. Budgetary positions of a large number of Member States deteriorated to the point that some countries have been posting persistent excessive deficits for considerable time now. This article demonstrates that this can be mainly attributed to the marked relaxation of fiscal discipline after 1997, in many cases virtually offsetting the efforts made in the preceding years. This budgetary loosening is due to a combination of factors, such as a gap in the regulations regarding the transition towards fiscal positions that are close to balance or in surplus, overoptimistic growth expectations around the turn of the century, the not so forceful corrective part of the Pact and difficulties concerning the assessment of fiscal positions.

Finally, this article outlines and assesses the Pact's recent reform. The latter includes less strict and more complex fiscal rules and significantly increases the Council's scope for interpretation. All parties concerned now have a great responsibility to apply the new framework properly and objectively. First, the Member States still reporting excessive deficits must reverse this situation as quickly as possible and establish and follow a credible adjustment path towards the new medium-term target based on realistic macroeconomic assumptions and clearly specified measures. Second, supervision of compliance with the new rules should be guided solely by the concern for sound public finances in the European Union.

Ultimately, the exact nature of the fiscal rules is less important than the actual fiscal developments. The easing of the rules does not necessarily result in a further deterioration of the budgetary situation in the EU, it only increases the scope for this to happen. In this respect it should be stressed that most Member States, quite apart from the monetary union and the related fiscal rules, urgently need a much sounder fiscal policy for other reasons too, such as population ageing, which will weigh more heavily on the budget in the near future. It remains to be seen whether those Member States that, despite the presence of strict fiscal rules, have not managed to avoid excessive deficits in recent years will be able to reverse this situation under more relaxed rules.