

EUROPEAN GOVERNANCE – THE STABILITY AND GROWTH PACT

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The Stability and Growth Pact was conceived in order to create a institutional uniform frame which could regulate the economic policies in the European Union. Even if it promotes strict fiscal discipline , in the last years the discontents over this document had an ascendant flow. Its reforming in the near future is undoubtedly necessary and represents one of the big challenges of the European system in the next years.

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Is the Stability and Growth Pact an efficient instrument for the governance of the European economy?

In order to back up or criticize this European Union measure of creating an uniform frame for the whole system , we have to understand the foresights and the objectives of this instrument. The European Community Treaty substantiates the coordination of the macroeconomic policies on three main levels:

- a common monetary policy designed by ECB with the main objective of the price stability
- fiscal policies delegated to the authorities from the member states with the primary objective of respecting the excess budget deficit procedure
- the procedure of Multilateral Surveillance of economic policies substantiated by ECOFIN and implemented by DLEP (Directive Lines of Economic Policies)

If we would try to reduce the SGP objectives to a primary one , this would be the limitation of budget deficits and the prevention of eventual crises in the members economies. There are experiments in order to find new possibilities to coordinate the macroeconomic policies in the EU , because the inconsistency between the monetary policy and fiscal policy are extremely visible. Theoretically , any asymmetrical shocks should be adjusted by the monetary policy designed by ECB , while the symmetrical shocks should be regulated by the decentralized fiscal policies .In reality , things get more complicated. The history proved that an efficient monetary policy is tightly correlated with a high credibility of the monetary institution , in our case , the European Central Bank.

Unfortunately , in the last years the ECB credibility suffered from various causes:

1. the lack of decisional transparency – There are voices who criticize the policy designed by ECB as being favorable to Germany while being unfavorable to states like France or Italy. This ultimate objective of price stability at any costs , seems to be in reality , the creation of a defensive instrument prepared to fight with the Germany nightmare – inflation. We should not forget that, in the last century from all the European countries , Germany suffered the most because of inflation (It is known , that during the First World War, the burning of banknotes for warming became more economic than the purchase of raw materials for heating). In this context , there is a real threat regarding the cohesion of the Monetary Union , especially because of the disputes between France and Germany on monetary subjects. The French authorities consider that ECB should use the rate exchange mechanism to equally stabilize inflation and secure economic growth , while Germany considers the price stability as the only viable goal of the monetary policy .
2. the economic growth of Euro Zone compared to the other rival commercial zones is relatively small (1%-1.5% - 2%-4% US and Japan or 8%-9% China)

The SGP foresights

- On short term - the budget could be in deficit , but cannot exceed 3% of GDP , while the structural budget deficit should be lower than 0.5% of GDP
- On long term – the state, social security and local communities budget should be balanced or in excess

In case a country runs a budget deficit bigger than the superior margin of 3% , and the budgetary situation isn't improving , the state in cause will be penalized with a sum equal to 0.5% of GDP. In order to strictly follow the Pact recommendations , an eventual recession would bring negative consequences through the simple fact that the Pact stimulates pro-cycle fiscal policies (Wyplosz). What do we understand through pro-cycle fiscal policies? A short example could enlighten us : in case of entering into a period of recession , the Pact stimulates restrictive fiscal policies (small budgetary expenses , high taxation level) , it is known that the economic theory considers that in case of a recession , the state should intervene for stimulating the aggregate demand through high budgetary expenses or a reduced taxation level. For avoiding these contradictions in period of crises , the SGP should be suspended in case of extraordinary circumstances in the global economy.

This document does not replace the fiscal policies of each member , in reality , through SGP the states only assume the consequences in case of infringement the 3% margin. In order to avoid these unpleasant situations , ECOFIN annually analyzes through Multilateral Surveillance the budget projections designed by the members through the Stability Pact (euro zone members) and Convergence Pact (members outside the euro zone) . In fact , Multilateral Surveillances , represents an economic policy guide designed by the Council , in which the economic performances of each member can be analyzed. Unfortunately , there are cases in which the projections created by the governments get a negative notification from the Council. For this purpose it is used an instrument named peer pressure which consists in preliminary warnings , the sanctions being strictly limited to the Euro Zone members.

Is the fiscal goal from SGP reasonable in the actual context?

In the last years , the Pact was often criticized to the high-point in which Prodi referring to it used the description – **Stupidity Pact** . Most of the critics refer to the 3% global budget deficit mark .The theory reveals that global budget deficit is formed from the structural budget deficit and cyclic budget deficit. The specialists are annoyed that the document underlines the global deficit , maintaining that it would be more efficient to be analyzed the structural deficit . What fundamentals has this affirmation? It bases on the fact that by managing the structural deficit , the influence of the business cycles or other fluctuations would be eliminated and the underlining of the structural deficit would allow economies to not sacrifice public investments. At this point, it appears the second main critic , which states that referring to the same target of 3% for all the members is unfair because their level of development is not similar. Unfortunately , respecting the budgetary criteria is expensive from the economic growth and unemployment point of view , and also on the other hand , it decreases the possibility of states to react to shocks.

The last 10 years analyze of the Monetary Economic Union , shows that the budget discipline was efficient. However , in the last years , after 2000 , most of the countries in the Euro zone didn't succeed in running budget deficit close to the equilibrium . This thing was determined by the fact that the states from the Euro zone no longer benefit from the reaction of the financial markets to the chronic deficits , the budget deficit evolving in an interesting modality of budgetary expenses adjustment.

The SGP credibility was deeply threatened when Germany and France violated the mark of 3%. It was an extremely strange situation because one of the initiators of the Pact , Germany , was amongst the first to infringe this document. It was a tensioned situation which had negative effects on the credibility , it was a new case of discretionary policy by the European Union , in which the states were treated different .

Anyway , the Pact of Stability and Growth has a series of advantages:

- Sustains budget discipline – The consequences could easily be recorded , in the actual context the European Union policy was restrictive , but less risky on the long term , compared to the US which created an economy of fabulous profits from the money market bubble to the housing bubble , with the cost of strong crises
- A coordination modality of economic policies

- Eluding the states conduct to adopt incoherent and risky budget policies to the whole system
- Budgetary harshness from the angle of public finances balance affected by the ageing process

Proposals for reforming the Pact

- The Pact should aim at the relation between public debt / GDP instead of budget deficit/GDP
- Multilateral Surveillance should be enforced in all the states – studies show that foreseeing the GDP can produce errors and omissions of 1% from GDP , the countries that infringed the 3% mark had tried to justify the failure by involving the errors in order to escape of the consequences .
- The theoreticians experiments of proving the compromise between inflation and deficit is no longer of present interest , the examples reveal that deflation is far more dangerous in the global context.
- SGP should be less strict on the 3% mark – the deficit target should be adjusted in relation with the business-cycles , but unfortunately in this case , we need an efficient statistic foreseeing on medium term. Meanwhile , this mark can be easily affected by several consecutive adverse shocks. We should be aware that budget investments along with the private ones have an extremely important role in economic growth and reducing them because of the strictness of the fiscal target would negatively affect the member states
- The creation of fiscal models by European Union’s specialists which can be used as viable examples for certain members that run an incoherent fiscal policy and adopt a clandestine passenger comportment – the actual form of the Pact encourage economies to reduce taxes and raise budget expenses in expansion periods , meanwhile in the recession periods it promotes the taxes raising and low budget expenses
- SGP , in its actual context creates big discrepancy between the member states economies – Ireland profits of the ECB monetary policy combined with a loose internal fiscal policy , running strong economic growth and a housing boom influenced by massive credit. Meanwhile, countries like England , and recently Spain start to experience the shock caused by the American housing crises , their economies recording a slowing of the economic growth . But moving the fiscal policy competences from the member states to the EU would raise the membership costs . In contrast with national governments , the European institutions are subject of a limited democratic control and so ,the enjoy reduced democratic legitimacy (Wyplosz).

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