



THE EURO IN CRISIS

By Tim Congdon

July 2005

**© Tim Congdon 2005
All rights are reserved.**

ISBN no. 1-903850-18-5

First edition published 2005

**Published by:
European Policy Forum
125 Pall Mall
London SW1Y 5EA
Tel: 020 7839 7565
Fax: 020 7839 7339
info@epfltd.org
www.epfltd.org**

Printed by Formara, UK

Contents

1.	Do the “no” votes threaten the euro?	1
2.	The rationale of the Stability and Growth Pact: a fundamental rule of fiscal prudence	2
3.	The rationale of the Stability and Growth Pact: the fiscal free-rider problem	9
4.	The breakdown of the Stability and Growth Pact	12
5.	The problematic position of the European Central Bank	15
6.	Conclusion: fiscal centralisation within a political union remains essential for the euro	18
	Notes	20

The euro in crisis

1. Do the “no” votes threaten the euro?

A standard argument in the debates about the introduction of the euro in the 1990s was that monetary union and political union were twin aspects of the European project. One formulation was that political union was necessary for the success of monetary union; another, which had been expressed by Monnet as early as 1957, was that monetary union would lead more or less inevitably to political union. (According to his biographer, Monnet’s exact words were “Via money Europe could become political in five years.” (1)) To the proponents of these points of view the “no” votes in the recent French and Dutch referenda on the European Constitution must have come as a nasty shock. It is clear that neither the European Union as a whole nor the subset of its members who belong to the eurozone will move to a fully-fledged political union over the next 10 or 20 years. If political union is indeed necessary for the monetary union to work, what will happen to the eurozone from here? Can the euro survive the now inevitable period of many years in which its constituent nations will remain essentially sovereign in tax and macroeconomic policy-making?

These questions have been made urgent by the calls by some leading Italian politicians for Italy to leave the eurozone and restore the lira. The purpose of this paper is not to provide exact answers and a precise forecast, because – as always in European affairs – so much will depend on personalities and political accidents. The aim is rather to review aspects of the economic relationship between budget deficits and inflation, and of the political interaction between the eurozone and its members, in order better to anticipate the likely course of events.

The first section will propose “a fundamental rule of fiscal prudence” to defend the original terms of the Stability and Growth Pact; the second will explain why an inter-governmental agreement like the SGP was required to overcome the fiscal free-rider problem from which the eurozone suffers (and will continue to suffer unless it becomes a fiscally-centralised political union); the third will discuss the difficulties in enforcing the SGP and the danger that one or more nations might break away from the eurozone; and the fourth will consider the problematic position of the European Central Bank. A final section will insist that political union is still needed if the eurozone is to be viable in the long run.

2. The rationale of the Stability and Growth Pact: a fundamental rule of fiscal prudence

When the SGP was first mooted, many economists claimed that its terms (i.e., the 60 per cent limit on the debt/GDP ratio and the three per cent limit on the deficit/GDP ratio) were “arbitrary”. Comments on similar lines have been made subsequently many times. For example, a 2004 paper on ‘The European Union: a politically incorrect view’ by Alesina and Perotti observed that “Economists have long tried to find an economic rationale for the budget deficit provisions of the SGP, with little success” and went on to say that their function was “largely political”. (2) This sort of low-key technical denigration of the SGP by academic economists undoubtedly goes some way to explain its poor reputation. When Romani Prodi described the pact as “stupid” in October 2002, he was not denounced for making an elementary blunder. The next few paragraphs will propose an analytical framework for thinking about the relationship between the public finances and the inflation rate, and argue that the contents of the SGP were neither arbitrary nor stupid. One conclusion will be that the 60 per cent debt/GDP and three per cent deficit/GDP numbers were sensible when the pact was introduced, but that the three per cent deficit/GDP number is no longer appropriate. In fact, the decline in the trend rate of output growth in the Eurozone over the last decade implies that the maximum permissible deficit/GDP ratio ought to be reduced.

The approach borrows from a standard result in growth theory, known as the Harrod-Domar equation. According to this equation, which holds in a steady state (i.e., a situation familiar to economic theory in which all ratios and all growth rates are constant), the growth rate of output is equal to the savings ratio divided by the capital/output ratio. A similar result, based on the same kind of simple algebraic development as that from which the Harrod-Domar equation is derived, is readily obtained for the relationship between,

- i. the ratio of the budget deficit (B) to national output (Y), and
- ii. the growth rate of nominal GDP.

The result could be called “the fundamental rule of fiscal prudence”.

As a steady state is assumed, we can let ‘a’ be the constant ratio of public debt (D) to nominal national output (Y). We have

$$D = a \cdot Y$$

and

$$dD = a \cdot dY,$$

where the d operator denotes the change in the variables. But the change in the debt is the same thing as the budget deficit. So

$$B = a \cdot dY$$

and

$$B/Y = a \cdot dY/Y.$$

In other words, the ratio of the budget deficit to output is equal to the debt/output ratio multiplied by the growth rate of nominal output. Now dY/Y is the growth rate of nominal output. As an approximation, at low inflation rates, the growth rate of nominal output can be regarded as the sum of the rates of increase of real output (g) and the price level (p). So

$$B/Y = a (g + p)$$

How does this bear on the Stability and Growth Pact? “Price stability” in the European context has for many years been interpreted as an increase in prices of between nil and two per cent, with two per cent being in principle the maximum. The trend growth rate of output in the Eurozone in the early 1990s would commonly have been estimated as three per cent a year. Then, with ‘ a ’ at the highest value prescribed in the treaty of 0.6, the implied *maximum* ratio of the budget deficit to output comes out as $(0.6 \times [2\% + 3\%])$, which is three per cent. In other words, with wide acceptance that public debt should not exceed 60 per cent of GDP (as in the Europe of the early 1990s), and given that the trend growth of nominal GDP consistent with low inflation was five per cent, the SGP’s three per cent limit on the deficit/GDP ratio emerged neatly and logically. It was in no sense “stupid”. (3)

The 60 per cent figure may still seem arbitrary, but it could be defended on several grounds. One rationale might be that – if the debt/GDP ratio exceeds a certain (fairly high) figure – savers need to be compensated for the risk of default and that puts upward pressure on real interest rates. With the real interest rate climbing, the increase in the debt/GDP ratio implies an even sharper increase in debt interest costs. These have to be covered by taxation, with all the adverse effects on incentives and resource allocation, or offset by lower non-interest expenditure. Another viewpoint might be that, to the extent that savers’ portfolios have a large holding of government debt, they have less room for claims on the private sector. As a result, the equilibrium capital stock (and equilibrium output per head) is lower in an economy with a high ratio of public debt to GDP than in one with a low debt/GDP ratio. Finally, the monetary control dimension needs to be mentioned. Public debt is being constantly redeemed and renewed, and the refinancing requirement (relative to GDP) is of course larger the higher is the debt/GDP ratio. Every refinancing puts strain on the capital markets, with a risk that the government may be unable to sell debt outside the banks. If the government has to borrow from the banks, that creates new money balances. These new money balances may or may not be undesirable, depending on whether money supply growth is currently appropriate relative to the inflation target. If they are undesirable, so also is the high debt/GDP ratio.

Now these three arguments about the significance of public debt – the debt interest burden and its effect on tax levels; the crowding-out of private investment; and the threat to monetary control from a large refinancing requirement – are controversial. Many

economists would reject all of them as misguided or even downright false, and would deny that they merit extended discussion. Perhaps so, but surely the arguments are not stupid. As it happens, the European Commission's Directorate-General for Economic and Financial Affairs produced a report last year on *Public Finances in EMU* which elaborated the arguments in more detail and quantified aspects of them. For example, it summarised a large body of research with the claim that

A significant impact of budget balances on interest rates is found especially in those analyses that employ measures of expected rather than actual budget deficits as explanatory variables. Concerning the magnitude of the estimated impact, most of the studies indicate that a 1 GDP point of additional deficit increases long-term interest rates on government bonds by between 20 and 100 basis points and long-term real interest rates by between 15 and 80 basis points. (4)

If a one-per-cent increase in the deficit/GDP ratio is plugged into "the fundamental equation of fiscal prudence" in a nation with a trend five-per-cent-a-year increase in nominal GDP, the debt/GDP ratio has to rise by 20 per cent in the steady state. If the real interest rate on long-term government bonds rises by 15 basis points because of the expansion of the budget deficit (i.e., if it rises by the lowest amount implied by the studies, as the Commission has interpreted them), debt interest costs increase as a share of GDP by $(0.015 \times [20 + \{\text{debt/GDP ratio before fiscal change}\}])\%$. If – for example – the debt/GDP ratio and deficit/GDP ratios were 60 per cent and three per cent in a nation with a trend annual increase in nominal GDP of five per cent, a real interest rate on the debt of three per cent and an inflation rate of two per cent, and if this nation went ahead with a trend one-per-cent increase in the deficit/ratio, the new steady-state would be associated with an 80-per-cent debt/GDP ratio and an increase in the ratio of debt interest costs to GDP of just over one per cent. (Of this one per cent, the bulk would be the interest on the 20-per-cent-of-GDP extra debt and 0.09 per cent would be the extra interest on the debt of 60 per cent of GDP associated with the previous steady state.)

This is not dramatic, but neither is it irrelevant to major public finance decisions. For a given ratio of tax to GDP and a given deficit/GDP ratio, an increase in the debt-interest-to-GDP ratio must entail a reduction in non-interest expenditure. The growth of the debt-holders' claims on the national cake eats into spending on teachers, doctors and nurses. What about the objection that the increase in the deficit/GDP ratio allows the government to spend more without an increase in taxation? The answer is that a boost to non-interest expenditure is possible only if the increase in debt interest costs is less than the increase in the deficit/GDP ratio. As shown in Table 1 (which is only a particular example, although not at all a silly one), when the deficit/GDP ratio rises to five, six or seven per cent, and the associated steady-state debt/GDP ratios climb to 100, 120 and 140 per cent, the fiscal arithmetic is unpleasant. The increase in the debt-interest-to-GDP ratio exceeds the increase in the deficit/GDP ratio.

Table 1 Some unpleasant fiscal arithmetic: does an increase in the budget deficit allow the politicians to increase non-interest expenditure?

In this example it is assumed that the desired trend rate of increase in nominal GDP is 5% a year. This 5% increase in nominal GDP is split, roughly, between 3% real growth and 2% inflation. The initial real interest rate on government debt is 3%, but rises by 0.15% for every extra 1% on the deficit/GDP ratio.

(1) Deficit/GDP ratio %	(2) Debt/GDP implied by the fundamental rule of fiscal prudence %	(3) Real interest rate on debt %	(4) Inflation rate %	(5) Debt interest costs, % of GDP
3	60	3	2	3
4	80	3.15	2	4.12
5	100	3.3	2	5.3
6	120	3.45	2	6.54
7	140	3.6	2	7.84

(1) Deficit/GDP ratio %	(6) Increase in debt interest costs as % of GDP: Relative to starting-point with 3% deficit/GDP ratio	(7) Excess of increase in debt interest costs over increase in deficit/GDP ratio, as % of GDP relative to starting-point
3	0	0
4	1.12	0.12
5	2.3	0.3
6	3.54	0.54
7	4.84	0.84

The message of the table is that - if a government increases the deficit/GDP ratio by 1% (for example, from 3% to 4%) - debt interest rises so sharply that the increase in debt interest costs exceeds the increase in the budget deficit. So, in the long-run steady state, non-interest public expenditure has to be lower than if the government left the budget deficit alone.

The need to accommodate the additional debt interest within the national budget implies either an increase in the tax burden or cuts in non-interest expenditure. Politicians' deliberate move into a wider budget deficit, which may arise from apparent generosity to the citizenry, does *not* enable them to spend a higher ratio of GDP on non-interest items. In fact, the indulgence in budget deficits is pure folly, as it requires *greater* restraint over non-interest public expenditure. The message emerges more vividly from Table 2, where the real interest rate on the public debt is taken to rise by 30 basis points for each extra one per cent on the deficit/GDP ratio. In this case an increase in the budget deficit has serious adverse effects on the debt interest burden in the new steady states. When the deficit/GDP ratio reaches six to seven per cent, either non-interest expenditure has to be cut, as a share of GDP, by between one and 1 3/4 per cent, or taxation has to rise, again as a share of GDP.

Table 2 Some unpleasant fiscal arithmetic: a particularly vicious case, where the interest rate on government debt rises by 30 basis points for every 1% on the deficit/GDP ratio

In this example - as in Table 1 - it is assumed that the desired trend rate of increase in nominal GDP is 5% a year. This 5% increase in nominal GDP is split, roughly, between 3% real growth and 2% inflation. The initial real interest rate on government debt is 3%, but rises by 0.15% for every extra 1% on the deficit/GDP ratio.

(1) Deficit/GDP ratio %	(2) Debt/GDP implied by the fundamental rule of fiscal prudence %	(3) Real interest rate on debt %	(4) Inflation rate %	(5) Debt interest costs, % of GDP
3	60	3	2	3
4	80	3.3	2	4.24
5	100	3.6	2	5.6
6	120	3.9	2	7.08
7	140	4.2	2	8.68

(1) Deficit/GDP ratio %	(6) Increase in debt interest costs as % of GDP: Relative to starting-point with 3% deficit/GDP ratio	Part of increase due to interest on extra debt relative to starting-point	Part of increase due to higher interest on original debt (i.e., of 60% of GDP)	(7) Excess of increase in debt interest costs over increase in deficit/GDP ratio, as % of GDP relative to starting-point
3	0	0	0	0
4	1.24	1.06	0.18	0.24
5	2.6	2.24	0.36	0.6
6	4.08	3.54	0.54	1.08
7	5.68	4.96	0.72	1.68

The penalty for fiscal laxity is more severe than in Table 1. Because the required return to bondholders rises by 30 basis points for every 1% on the deficit/GDP ratio, and the debt/GDP ratio in the steady state rises by 20% for every 1% on the deficit/GDP ratio, an increase in the deficit/GDP ratio from 3% to 7% necessitates a reduction of almost 1 3/4% of GDP in non-interest public expenditure.

Evidently, when a lurch into deficit financing leads to a rise in the debt/GDP ratio the outcomes are unpalatable. It is true that the increase in the budget deficit is not necessarily associated with an increase in the debt/GDP ratio. The fundamental rule of fiscal prudence could be met in a different way, by a rise in the inflation rate. Thus, with the trend growth rate of output given at three per cent a year and the debt/GDP ratio also given at 60 per cent, the inflation rate implied by a deficit/GDP ratio of three per cent is two per cent. (This figure is obtained by deducting the trend growth rate of output, per cent, from [the deficit/GDP ratio divided by the debt/GDP ratio] multiplied by 100, per cent.) By the same reasoning, the inflation rate implied by a deficit/GDP ratio of four per cent is 3.6 per cent and that implied by a deficit/GDP ratio of five per cent is over 5.3 per cent. Of course a deterioration in inflation of this kind would tarnish the image of the euro and is certainly not to be welcomed.

The reasoning in the last few paragraphs constitutes a powerful argument for the fiscal rules contained in the SGP. In essence, if governments breach the rules, they are punished either by a rise in interest costs associated with a higher steady-state debt/income ratio or by extra inflation. Nothing is to be gained by fiscal laxity, and Europe's politicians as a group are deluding themselves and their electorates in the aggregate if they engineer a larger Eurozone budget deficit in the belief that this would somehow make everyone better-off. Further, it seems plausible that the numbers in the original SGP were chosen with a particular macroeconomic context in mind. As we have seen, the three-per-cent deficit/GDP and 60-per-cent debt/GDP numbers made sense in European economies with an assumed trend growth rate of nominal GDP of five per cent, where this five per cent was split between two-per-cent inflation and three-per-cent real growth.

Do the numbers in the SGP still apply today? Is the macroeconomic context now much the same as it was in the early 1990s? The answer is, "Certainly not. The underlying growth rate of Eurozone output has fallen and is likely to decline again from about 2010 as the demographic trends become less favourable". Most observers would say that the underlying growth rate of Eurozone output has fallen from three per cent a year to $1\frac{1}{2}$ per cent a year. It follows that the deficit/GDP ratio consistent with a 60-per-cent debt/GDP ratio in a steady state with two-per-cent inflation is now not three per cent, but about two per cent. (To recall the formula, it is 0.6 multiplied by [output growth plus inflation, which is $3\frac{1}{2}$ per cent in this case], i.e., 2.1 per cent.) The relaxation of the SGP currently under way is a move in exactly the wrong direction. The fall in the Eurozone's trend growth rate since the early 1990s argues that the maximum deficit/GDP ratio should be lowered, not increased.

Unfortunately, Europe's leaders show no sign of recognising the logic which justifies the case for fiscal prudence. Indeed, fiscal restraint is proving particularly difficult in those nations where the macroeconomic background is least favourable for fiscal expansionism. It has to be admitted that the application of the fundamental rule of fiscal prudence at the national level may be politically contentious. A clear implication of the rule is that nations with relatively low trend rates of economic growth should also have budget-deficit-to-output ratios lower than the average. So the maximum B/Y ratio for Germany – with a trend growth rate of, say, one per cent – is $(0.6 \times [1\% \text{ inflation} + 1\% \text{ output growth}])$, which is 1.2 per cent, whereas for Ireland – with a trend growth rate of perhaps five per cent – it is 3.6 per cent. But, partly because of the strength of "fiscal drag" in the tax system and other influences, it is politically easier to control budget deficits in high-growth nations than in low-growth nations.

One point of clarification needs to be made before moving to the next section. The fundamental rule of fiscal prudence applies in a steady state (i.e., to repeat, when the ratios between key variables are unchanged and the variables themselves are growing at the same constant rate). The notion of "the steady state" is theoretical and somewhat artificial, and is unlikely to correspond closely to real-world situations. Take the proposition that a one per cent increase in the deficit/GDP ratio implies, in the steady state with the debt/GDP ratio fixed at 60 per cent, an increase in the inflation rate of just under $1\frac{3}{4}$ per cent a year. That may look definite and precise, but it does *not* mean that in

every single year after such an increase in the deficit/GDP ratio inflation is higher by exactly $1\frac{3}{4}$ per cent a year than before. Inflation is subject to a wide variety of influences in the short run and should not be mechanically related to fiscal variables in this way. Rather a reasonable expectation is that, on average over a number of years with the debt/GDP ratio given at 60 per cent, the inflation rate associated with a deficit/GDP ratio of 4 per cent will be between $1\frac{1}{2}$ and 2 per cent higher than that associated with a deficit/GDP ratio of 3 per cent. Moreover, in almost any conceivable real-world situation the debt/GDP ratio will vary from year to year and muddy the short-term relationship between the deficit/GDP ratio and the inflation rate. Further, the analysis needs to be integrated with a monetary account of inflation if it is to be comprehensive and persuasive.

3. The rationale of the Stability and Growth Pact: the fiscal free-rider problem

The fundamental rule of fiscal prudence is applicable to any political entity, although the emphasis here has been on the European context. Implicitly, the references to “the deficit/GDP ratio” and “the debt/GDP ratio” have been to these variables in the eurozone as a whole, as if it were a nation state and its finance ministers acted in unison. However, the eurozone is not a nation state and its finance ministers do not act in unison. Indeed, the eurozone is a quite unique and rather extraordinary geo-political construction. Never before has a common currency been reconciled with such a degree of fiscal decentralisation. As has frequently been remarked, the difficulty of maintaining fiscal restraint over nations in a monetary union of the present type is greater than that of maintaining fiscal restraint over local authorities and government departments in a fully-fledged nation state. Europe’s monetary union suffers from a very serious fiscal “free-rider problem”.

A unitary nation state has one government, one central bank and one currency. Local authorities and government departments may exceed expenditure ceilings imposed by a central finance ministry, but sanctions can be enforced against the errant local authorities and departments. In the extreme senior finance ministry officials, backed up by their political masters, may seek the dismissal or even imprisonment of over-spending local politicians or departmental bureaucrats. (According to Weber, the state can be viewed as the organization which “successfully claims the monopoly of the legitimate use of physical force”. (5)) The blame for failing to keep inflation down therefore falls – very clearly – with one government and one central bank. If the government runs a large deficit, borrows from the banking system and causes rapid money supply growth, it is easy to finger the culprits. The chain of fiscal accountability may be more complex in federal states. Nevertheless, decades or centuries of experience have usually built up a body of administrative or legal precedent which identifies those responsible for over-spending and restrains them before they go too far. For example, in the United States of America the 50 states accept the convention that they should maintain balanced budgets over the long run.

The trouble with the European monetary union of today is that it has one central bank, one currency *and 12 governments*. The governments are of nation states which retain the key levers of fiscal sovereignty within their own borders. Specifically, they all have central finance ministries and national tax-collecting authorities, while decisions taken by these bodies are enforced by legal structures (and ultimately by police forces) at the national level. But the eurozone itself has no levers of fiscal sovereignty. It has no central finance ministry, no tax-collecting authority and no police force.

The free rider problem arises because one (or two or even more) of the 12 member states may run a large deficit, but still enjoy the currency stability attributable to fiscal control in the other 11 (or the other ten, nine or whatever the number may be). Of course, if two eurozone governments have the same ratio of public spending to GDP, the government

running a balanced budget is taking four per cent more of GDP in taxes than a government running a deficit of four per cent of GDP. If no penalty has to be paid for running a deficit of four per cent of GDP, the temptation to incur a deficit and operate with lower taxes is difficult to resist. In general, if all the nations have similar ratios of public expenditure to GDP, high-deficit nation(s) have lower taxes and in that sense cheat on the rest. Moreover, if a few governments behave like free riders and are not punished, other governments may feel obliged to cut taxes and help their own citizens (and, temporarily, to boost their own political popularity). As control starts to slip, what is the constraint on fiscal incontinence? Is there any limit at all? If a deficit equal to four per cent of GDP is not met with sanctions of some kind, why not slip to five per cent of GDP? And then what is wrong with six per cent? And so on.

The express purpose of the SGP was to establish a benchmark by which fiscally delinquent governments could be measured, isolated and punished, and so to pre-empt free-rider behaviour. The SGP was necessary, in order to establish at the level of the eurozone a numerical framework of fiscal restraint analogous to the frameworks which had long applied at the level of the member states. Of course, without a centralised finance ministry, a tax-collection agency dedicated to its own purposes and so on, the eurozone was bound to have great difficulty implementing such a framework. However, the SGP did contain a mechanism for punishing nations which breached the three-per-cent-of-GDP deficit limit. This mechanism – known as “the excessive deficits procedure” – envisaged the imposition of fines on nations with deficits above the three-per-cent-of-GDP figure. The fines were to be proposed by the European Commission after inspection of the offending government’s books and had to be endorsed by qualified majority voting in the Council of the eurozone’s 12 finance ministers (sometimes called “the Euro Group”). (Note that the Euro Group is distinct from Ecofin, or the Council of Finance Ministers, which includes the finance ministers of both the eurozone and three EU countries outside the eurozone, i.e., the UK, Sweden and Denmark.)

The excessive deficit procedure has always looked implausible. In particular, many sceptics wondered well before the euro’s inception in January 1999 whether a qualified majority vote to impose a fine would ever emerge in the Euro Group. One highly predictable problem was that – if several governments had excessive deficits – they would form a blocking minority and so prevent a fine on any one of them. Even if only one nation were delinquent and a fine had been recommended by the European Commission, a vote by the finance minister of a low-deficit nation for a fine on a high-deficit nation would be an act of considerable unfriendliness. And would countries with public finances which are satisfactory now but might deteriorate at a future date gang up on one or more countries with public finances which are already unsatisfactory? Why would any country constrain its freedom of manoeuvre in that way? No government – even one with a healthy budget surplus today – can be confident that its public finances will stay in good order indefinitely.

The excessive deficits procedure was particularly implausible if the fine were to be levied on Germany, as it was (and remains) the largest net contributor to the EU’s finances. Had no one worked out that Germany might retaliate by cutting the amount of money it gives

to the EU? However, if Germany were for this reason effectively immune to the excessive deficits procedure, a failure to fine Germany for a deficit of four per cent of GDP would serve as a precedent. If Germany, the largest member, could not be fined, could the excessive deficits procedure be enforced against any nation with a four-per-cent-of-GDP deficit?

The eurozone has now been in existence for over five years. Have the sceptics been right? How serious has the free rider problem been in practice? And has it been tamed by the excessive deficit procedure or not?

4. The breakdown of the Stability and Growth Pact

The euro has many problems, but it also has remarkable achievements to its credit. One of the most signal achievements came in the mid- and late 1990s. By making membership of the eurozone an ambition for all EU nations, the single currency project spurred a dramatic improvement in their public finances. This beneficial effect was greatest in those nations – such as Italy, Spain, Belgium, Portugal, Greece and Ireland – which had historically run large budget deficits. The ratio of their combined budget deficits to the GDPs of the 12 eurozone nations was over 5 ½ per cent in 1993. As governments worked towards the deficit and debt targets spelt out in the Maastricht Treaty and reiterated in the SGP, this ratio dropped to under three per cent in 1997 and to roughly one per cent in 1999 and 2000. The concerted move towards fiscal discipline was impressive. It goes a long way to explain the good performance of the euro, in terms of low inflation and macroeconomic stability, in its early years.

However, fiscal consolidation was more apparent than real. A wide variety of accountancy tricks enable governments to understate the “true” deficit. Programmes may run for several years, giving ministries discretion about when to date the expenditure; cash payments may be timed differently from either the ordering or delivery of goods and services bought by the public sector, so that the accruals deficit is different from the cash deficit; the state owns assets and makes loans, and the precise boundary between public and private ownership is a matter of convention, allowing the government to shift assets into the public sector at convenient moments and so to reduce its deficit; the valuation of assets (such as gold reserves) is to some extent at official discretion and revaluations may be helpful for presentational purposes at certain times; and so on. There is no doubt that the high-deficit governments used these tricks extensively in the years from 1996 to 2000 in order to meet the Maastricht criteria. They correctly judged that the priority was to qualify for eurozone membership. Once they were inside an operational system, the process of expelling them would be extremely difficult.

Of course the truth about the public finances had to emerge sooner or later. Nearly all expenditure leads eventually to a cash payment and a cash payment has to pass through the banking system, where it is recorded. The opening years of the eurozone therefore saw sizeable upward revisions to the budget numbers provided by some nations. The data from Greece and Portugal proved particularly suspect. It turned out that Portugal had barely qualified for the eurozone in the first place. At the start of 2002 Portugal’s deficit/GDP ratio was thought to have been 2.1 per cent in 1999 and 1.5 per cent in 2000, both comfortably within the required three-per-cent figure. By early 2004 the deficit/GDP figures for the two years had been revised upwards to 2.8 per cent, and cynics might comment that this was so close to the three-per-cent ceiling as to raise more doubts. Almost certainly Greece, which joined the eurozone on 1st January 2001 (i.e., two years after the other 11 members), had never – strictly speaking – been eligible. On the initial figures supplied to the European Commission its deficit/GDP ratio was only 1.1 per cent in 2000. But – according to the January 2005 issue of the ECB’s *Monthly Bulletin* – the 2000 figure was in fact 4.1 per cent. The latest data – which may or may not be the full story – show that Greece had a deficit/GDP ratio in 2004 of no less than 6.1 per cent.

Moreover, at the time of writing (June 2005) the talk is that Portugal may have a deficit/GDP ratio of almost seven per cent in 2005. Deficits of six and seven per cent of GDP are obviously inconsistent with the SGP.

The imposition of the excessive deficits procedure on Greece and Portugal seems essential if the SGP is to retain any credibility. But they could protest that – if the Euro Group were to take this step – it would be discriminating against the small and relatively powerless members of the club. Their case would be that the Euro Group has not been prepared to enforce the procedure against Germany and France. Both these big countries have become quite brazen in their refusal to lower their deficit/GDP ratios to under three per cent and are openly breaking the rules. (According to the April 2005 issue of the European Central Bank's *Monthly Bulletin*, in the three years 2002 to 2004 inclusive the deficit/GDP ratios in Germany were 3.7 per cent, 3.8 per cent and 3.7 per cent respectively, and in France 3.2 per cent, 4.2 per cent and 3.7 per cent.)

So far no nation – not even Greece or Portugal, despite their egregious departure from the SGP's norms – has been subjected to the excessive deficits procedure. But on 8th June 2005 the *Financial Times* carried a story, under the headline 'Italy first to face action over growing budget deficit', which opened with the statement, "Italy was yesterday put in the dock as the first country to face disciplinary action under the European Union's revamped stability pact, amid fears that public borrowing in the eurozone is getting out of hand". The EU's monetary affairs commissioner, Joaquin Almunia, was said to be

determined to show that fiscal discipline had not broken down by starting proceedings against Italy. Mr. Almunia's report, adopted by the Commission in Strasbourg yesterday, highlighted how Italy had used faulty statistics to hide the fact that it had broken the pact's rules in 2003 and 2004. He also predicted 'excessive deficits' in 2005 and 2006.

With the Italian prime minister, Silvio Berlusconi, defiant that Italy has the right to cut taxes, the Commission and the Italian government appeared to be on collision course. However, the latest reports are that the Commission and the Italian government have reached an understanding, with the deficit to be brought back to an acceptable level in 2007.

The tension may return next year if Italy's budgetary plans remain unsatisfactory, but it is far from clear that finance ministers in the Euro Group will assemble a qualified majority vote for a fine. Italy has a potentially drastic response, to leave the eurozone altogether. At the same time that Almunia was collating evidence that Italy had breached the SGP, leading members of the Northern League – which is part of Italy's governing coalition – called for a return of the lira. (Indeed, the story in the *Financial Times* on the Northern League's anti-euro position appeared alongside its story on the emerging case for the application of the excessive deficits procedure to Italy.) Roberto Castelli, the Italian justice minister, pointed out that the UK, Denmark and Sweden were in perfectly good economic shape, despite staying out of the eurozone. If the Euro Group does take the excessive deficits procedure to its logical conclusion and fines Italy, anti-euro sentiment

seems likely to strengthen and to become a factor in Italian politics. Although the re-introduction of an Italian national currency would involve huge contractual uncertainty, great complexity and significant expense, it is feasible. Arguably, the damage to Italy itself would be greater than that to the other eurozone members, but it would be a setback for all the countries involved. If Italy could leave, what is to stop other nations? Any fiscally embarrassed nation about to face the excessive deficits procedure could threaten to pull out.

Given the challenge to the eurozone from recent events, it would surely be diplomatic for Germany – the nation with Europe’s largest economy – to try to calm the situation. But that has not been the approach taken by Gerhard Schroder, Germany’s Chancellor. At the March 2005 meeting of the Euro Group Schroder proposed that the SGP’s enforcement powers should be taken from the Commission and returned to national capitals. Jean-Claude Juncker, president of the Euro Group (and also prime minister and finance minister of Luxembourg), had to slap down the idea. As *Institutional Investor* correctly remarked in its March 2005 issue, if fiscal control were again located entirely at the national level, that “would effectively dismantle the pact”. Juncker later remarked of Schroder, “He is not in charge of the European economies. He is not a head of state, either. He’s just a head of government.” (6) (Germany’s GDP in 2003 was \$2,400b., Luxembourg’s \$26b.)

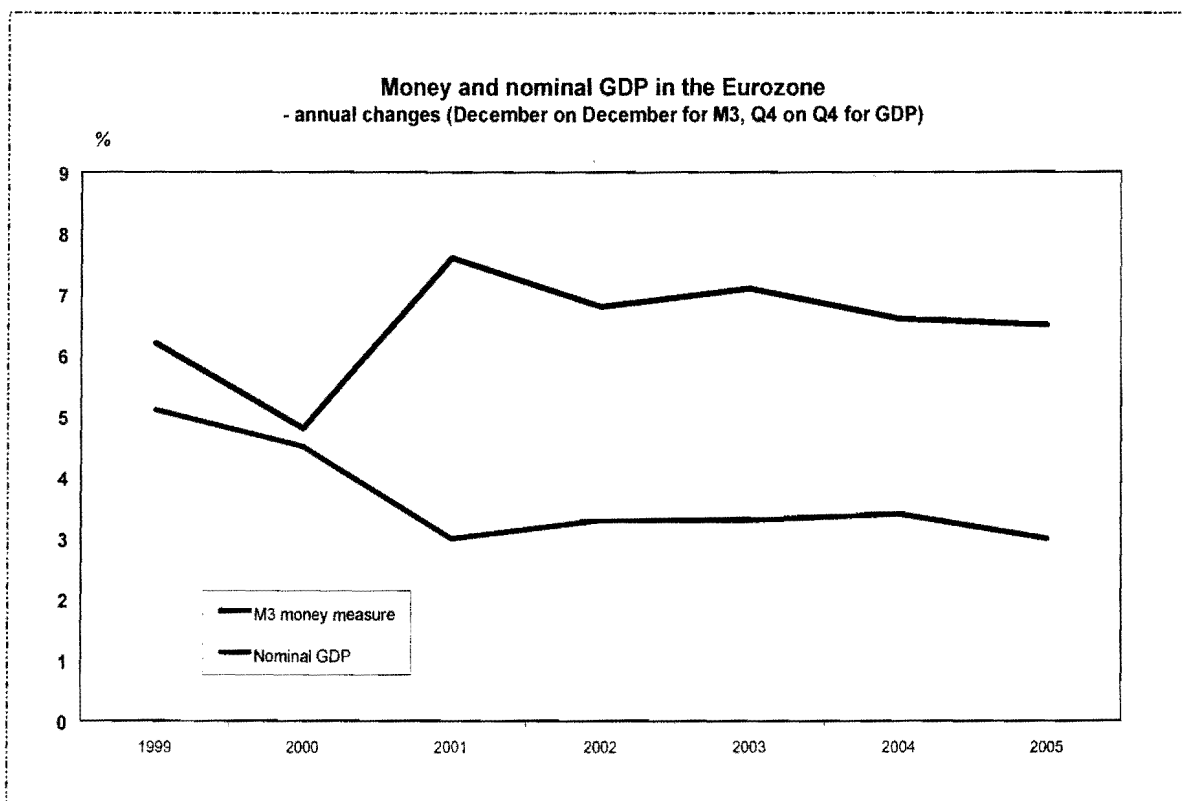
To say that the SGP *has* broken down may be going too far. But to say that the SGP *is* breaking down is surely justified.

5. The problematic position of the European Central Bank

The ECB – like the Bundesbank before it – has been one of Europe’s most successful post-war institutions. Germany’s recovery of power and international respectability after 1945 came, at root, from the impressive performance of its currency, the deutschemark; and for most of the post-war period the management of the deutschemark was the responsibility of the German central bank, the Bundesbank. The key to the Bundesbank’s success was its commitment to a simple idea, that the value of money depends on its quantity. German economists had learned in the Weimar hyperinflation of 1923 that too much money creation causes prices to increase and that an excessive budget deficit can lead to too much money creation. By the terms of the 1957 legislation which established it, the Bundesbank could not lend to the German government and was expected to deliver a sound currency by appropriate monetary restraint. The same underlying principles – that governments should avoid excessive budget deficits and should never borrow from the central bank, and that inflation is to be avoided by control over the quantity of money – are alive today. They were contained in the treaties that forged the eurozone and in the body of understandings which now determine the ECB’s behaviour.

Despite the alarums and excursions of eurozone fiscal policy, and the growing hullabaloo in the Euro Group, the ECB has so far done a superb job. Its main objective has been to maintain very low inflation (or so-called “price stability”), by keeping the increase in the consumer price index at between zero and 2 per cent. However, in the highly political and compromised real world, few would expect it to achieve a number much under 2 per cent. The actual increases in the eurozone CPI in its first six years of responsibility for the single currency (i.e., the six years to 2004) were 1.1 per cent, 2.3 per cent, 2.3 per cent, 2.3 per cent, 2.1 per cent and 2.1 per cent. The average number was therefore exactly 2.0 per cent. The record is all the more commendable, when it is remembered that the euro was very weak on the foreign exchanges in its first two years and that inflation has diverged sharply between the member states.

Moreover, it has stuck to its principles. Whereas central banks in the English-speaking world are confused about the relationship between money and inflation, the ECB has retained money supply targeting as one of two pillars of its policy-making. The editorials in its *Monthly Bulletin* since 1999, like the analogous sections in the Bundesbank’s *Monthly Report* over the previous 25 years, make frequent references to the money supply (on the M3 measure), and emphasize the relevance of money to the outlook for economic activity and inflation. It has to be said that the defence of the essentially German principles of sound money has become more difficult in recent years, because a significant gap has opened up between the growth rates of the M3 money measure and nominal GDP. (See the accompanying chart.) The debate about monetary policy has become particularly intense in recent quarters. High monetary growth has coincided with weak consumer spending and gloomy business surveys, raising doubts about the validity of the ECB’s emphasis on the money supply.



The ECB has not let the apparently flawed relationship between money and national income deter them from expressing concern about large budget deficits. The April 2005 issue of the *Monthly Bulletin* was particularly vocal. In its words, “Given that inappropriate [fiscal] consolidation strategies and shortcomings in their implementation have, in the past, made compliance with the SGP difficult, it is now essential that consolidation plans are ambitious and are fully implemented. It is equally essential that the European Commission and the ECOFIN Council strictly enforce the new agreement on the implementation of the Pact so as to restore the framework’s credibility.” The “framework” mentioned here is the same as that which guided German macroeconomic policy so successfully from the 1950s and which, according to the treaties, ought today to be operational at the European level.

Perhaps unfortunately, the ECB draws its legitimacy only partly from its record. In the final analysis it is the creature of international treaties which were agreed by politicians, often by diplomatic horse-trading late at night. In the enforcement of the SGP the ECB is inevitably allied with the European Commission; and in the application of penalties under the excessive deficits procedure the ECB and the Commission would be pitted together against politicians from the member states. This is an unenviable role. The deficit/GDP ratio for the eurozone as a whole was only one per cent in 2000, but it was almost three per cent in 2004. On current trends the number could move out to four per cent in 2005 or 2006. The ECB can only lodge verbal protests in its publications and in the speeches of its council members. Ultimately it has no power to discipline member governments. It

could try to counter the *long-run* inflationary risks of excessive budget deficits by raising interest rates, as a gesture to warn the politicians. But – if an interest rate move of this kind were not also justified by the macroeconomic conjuncture (i.e., by *short-run* inflation pressures) – it would be outside the ECB's remit and far too politically controversial.

As far as possible interest rate decisions need to be based on technical economic arguments, not on wider political considerations. At present the ECB has a difficult task persuading politicians in low-growth countries that an interest rate cut would be unwise. Rather high money supply growth in the eurozone as a whole has been accompanied by house price booms in some member states, such as France, Spain and Ireland. The outlook for manufacturing in the low-growth countries (of which Italy is a salient example) may seem to establish a case for lower interest rates, but the ECB must think about the entire eurozone. The tension between pessimistic business surveys and positive monetary trends is awkward for the ECB, and leaves it vulnerable to politically-motivated criticism if it takes the wrong interest rate decision on technical grounds.

Unless the eurozone becomes an authentic nation state, the ECB will always be a convenient scapegoat for populist and even nationalist politicians in the member states. Like the Commission, it is supposed to be outside and above politics. But it will have full legitimacy only when it is answerable to a parliamentary body with genuine European-wide democratic credentials. Supporters of European integration might say that the European Parliament is already such a body. But the European Parliament vies rather confusingly with national parliaments, and – despite the treaty-making of the last 20 years – Europe's finance ministries and tax collection agencies still answer to these parliaments. As long as the eurozone is a monetary union without a political union, the constitutional position of the ECB will be problematic.

6. Conclusion: fiscal centralisation within a political union remains essential for the euro

European integration has been a more or less continuous process since the early 1950s, but it has had the occasional zigzag, and its moments of paradox and comedy. For over 30 years Germany was the driving force behind European monetary integration, seeing the establishment of the single currency as key to the forging of political union. Over the years numerous statements were made by German politicians that a properly conceived monetary union would necessitate political union. If the phrase “political union” meant anything in this context, one of its aspects was surely a degree of centralised control over public finances. Ideally, a European finance ministry and finance minister had to be granted powers superior to those of national finance ministries and finance ministers, and both tax collection and expenditure control needed to be centralised, as they are in nation states. But none of the treaties dared make suggestions as ambitious as this.

For economists who have long had their doubts about the extent to which member governments would be prepared to surrender powers to EU institutions, the spat between Juncker and Schroder at the March meeting of the Euro Group has to be described as highly predictable as well as deliciously ironic. Given Germany’s long-standing commitment to both monetary and political union, Schroder’s call for a repatriation of fiscal control can only be described as astonishing. The large message is that serious tensions in the surveillance of public finances are emerging between the Commission and national finance ministries. Inevitably, different nations have different accounting standards in their state sectors and they enforce these standards with varying degrees of rigour. Without enforcement powers similar to those in a genuine nation state (i.e., the ability to apply legal sanctions against errant local politicians and officials), the Commission is ultimately powerless to control over-spending and statistical tricks at the national level.

The introduction of the euro was the most daring step in the long process of European integration. The UK’s former foreign secretary, Douglas Hurd, even characterised it as “a Maoist leap”. There is no question that – with open speculation about the departure of one or more of its member states – the eurozone is in crisis. If Europe’s politicians want to restore the credibility of the single currency project, they need quickly to agree a new treaty which would envisage a eurozone-wide finance minister and a eurozone authority empowered to apply public finance rules uniformly to all members. Further, they need to be frank with each other that this authority would evolve over a few years to become a fully-fledged eurozone finance ministry, superior to national finance ministries just as the ECB is now superior to the national central banks.

The European Constitution did not envisage a eurozone finance minister, but it did propose a foreign minister for the whole of the EU. If the Constitution had been adopted by all 25 member states, another treaty including an EU (or at least a eurozone) finance minister would probably have emerged. But, after the “no” votes in the French and Dutch referenda, the notion of a eurozone finance minister is plainly premature, if not downright silly. While views differ among Britain’s politicians, the UK government must now feel

glad not to have adopted the euro. But the message seems to be that the British people are not alone in their suspicion of further European integration. Fiscal centralisation within a fully-fledged political union is a precondition for success in a monetary union. But the necessary degree of fiscal centralisation will not occur in Europe for the next 20 or 30 years, and doubts have to be raised whether the eurozone can survive that long.

Can anything more definite be said about the timing of a member state's departure from the eurozone? The tensions could surface in several places. The euro will remain a good currency while the quantity of money is kept under control, but the ECB may find it impossible to prevent a high-deficit government borrowing heavily from the banks. The ECB might then ask the Commission to take steps against the government concerned. Alternatively, the excessive deficits procedure may be enforced. The government subject to the fine would have to calculate whether the costs of staying in were higher or lower than the costs of leaving. Of course, the fine itself would be part of the cost of staying in. Huge uncertainties would be opened up. As *The Economist* noted in its edition of 11th June 2005, prime minister Berlusconi did not condemn "the substance" of the Northern League's proposal for Italy to leave the eurozone. A fair surmise is that – despite the damage that would be done to the credibility of Italian economic policy if its currency left the eurozone – Berlusconi does not want his country to be taken for granted. He wants the other members of the eurozone to believe that Italy could leave.

The key message of the fundamental rule of fiscal prudence, as proposed in the second section of this paper, is that deliberate increases in budget deficits are likely either to raise debt interest costs by more than the increase in the budget deficit or to increase inflation. Given that very low inflation is essential to the continued popularity of the euro, an economically unsustainable course of action must also – in the end – be politically dangerous and unacceptable. The UK's abstention from the eurozone has preserved the chain of fiscal accountability and the transparency of macroeconomic management found in traditional European nation states. Unless the eurozone's leaders are able within the next few years to enforce genuine fiscal centralisation across the 12 member states, a reasonable conjecture is that the UK's fiscal arrangements will look increasingly satisfactory by comparison.

Notes

(1) See p. 88 of Christopher Booker and Richard North *The Great Deception* (London and New York: Continuum, 2003), drawing the quotation from p. 312 of Francois Duchene *Jean Monnet: the First Statesman of Interdependence* (New York: W. W. Norton and Co., 1994).

(2) Alberto Alesina and Roberto Perotti 'The European Union: a politically incorrect view', Working Paper no. 10342, *NBER Working Paper Series* (Cambridge, Massachusetts: National Bureau of Economic Research, 2004), p. 13.

(3) The "fundamental rule of fiscal prudence" makes no reference to the behaviour of money, but is fully consistent with a monetary view of inflation. (See Tim Congdon 'The link between budget deficits and inflation: some contrasts between developed and developing countries', pp. 72 – 91, in Michael Boskin *et al* [eds.] *Private Saving and Public Debt* (Oxford and New York: Blackwell, 1987, for further discussion.). It also applies only in a steady state. In the real world the ratio of public debt to national output is always changing. *High and even rising B/Y ratios can therefore be reconciled – for a period – with low and possibly falling inflation.*

(4) European Commission *Public Finances in EMU* (Directorate-General for Economic and Financial Affairs, EC: Brussels, Belgium, 2004), p. 150.

(5) See p. 67 of Anthony de Jasay *The State* (Blackwell: Oxford and New York, 1985), quoting from Max Weber *Essays in Sociology*, 1946, p. 78.

(6) Tom Buerkle, 'Looking for Mr. Euro', *Institutional Investor* (March 2005), p. 30.

EUROPEAN POLICY FORUM

*125 Pall Mall
London SW1Y 5EA*

*Tel: +44 (0)20 7839 7565
Fax: +44 (0)20 7839 7339*

www.epftd.org

ISBN no: 1-903850-18-5

£10