The Political Economy of the Stability and Growth Pact

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The European Economic Governance

• Since 1992 (Maastricht treaty) dialectics of two movements:
  • Pluralism: power of bureaucracies and national powers
    • European Council
  • Centralization: desire to reduce the autonomy of the national democratic governments and the welfare state
    • ECB

• Economic convergence or asymmetry

• 2001 and 2011 important institutional steps
Maastricht

• 1992 Maastricht Treaty

• 1998 ECB e ESCB: price stability (and others...), independent and prevented from buying sovereign bonds on primary market
  • French traditionalism and ordoliberalism
  • Barro & Gordon: inflationary tendencies of politics
  • Policy by the rule
  • Market rationality and equilibrating effect of price movements
Stability and Growth Pact

• 1997: 3% deficit/GDP (no indications about budget composition)
  • OMT
  • CTBOIS
  • Infraction procedure

• The debate:
  • Deflationary tendencies
  • Financial fragility: no lender of last resort
  • EU as a new financial center
  • Neomercantilism: current account surplus
2001 Crisis

• Conflict ECOFIN-Commission
  • Two factions: The Netherlands, Austria, Luxembourg, Portugal, Spain with the Commission – Germany and France (with Italy and Greece) in favor of relaxing budget rules

• Infraction procedures. The defense:
  • EC needs to consider budget composition: investment?
    • One off measures: exceptional sales of public assets, financial operations (Goldman Sachs, JP Morgan Chase)
  • Mistakes in the EC’s forecasts

• The cyclically adjusted budget from problem becomes solution – in 2002 a new formula
Stability and Growth Pact Reform in 2005

• Hans Eichel: external disciplinary constraint: avoid political responsibility domestically

• Peter Doukas: there will always be exceptions

• The compromise of 2005: a step toward *pluralism*
  • Longer time frame for adjustment
  • A list of exceptions to relax rules in the medium term: public investments, emergencies, pension reforms..
  • Fiscal target expressed as estimate
  • Conditionality principle

• Austerity as a choice! But inadvertedly they create a core-periphery dynamics
The Structural Budget

• Why adjust the budget? Actual balance can be misleading. But estimates depend on prevailing theory
  • 1944: High Employment Budget
  • 1960: Full Employment Budget

• 1980: cyclically adjusted budget or structural budget
  • Potential equilibrium is the norm
  • Supply-driven
  • NAIRU
The Formula of the EC

• NAWRU and elasticity

  Cyclical component = s*output gap

• $s$ is sensitivity of budget to cycle
  • Tax rates, expenditure rates but also income distribution

• Estimates of potential output depend on institutional conditions

• The technical judgement of the Commission becomes more important
Figure 3: In blue the actual unemployment rate and in red the NAWRU, data downloaded from AMECO in 2013, at the peak of the sovereign debt crisis. The Commission estimated at the time that Spain had a 24% optimal rate of unemployment.
An Unreliable Estimate

Figure 2: Estimates of Output Gap for Italy by the Commission at different times. Colors show the year in which the estimate is made and the dots show the years to which the estimate refers. Source: EUROPEAN COMMISSION DIRECTORATE GENERAL ECONOMIC AND FINANCIAL AFFAIRS, Assessment of Italy's Stability Programme from 2014 to 2018 (Spring estimates)
2008 Crisis

• Conditions for a new change
  • With banking crisis and following sovereign debt crisis, the divergence between core and periphery are unveiled
  • The geography of power has changed: Surplus countries have power over deficit countries

• Solidarity is conditional on reforms
  • The Deauville walk, 18th October 2010: French-German agreement on the Private Sector Involvement: Ireland, Portugal and then Spain and Italy

• An artificially generated emergency, easily solvable, prepared the terrain for a new reform toward centralization
Figure 8. Total government disbursement in real terms (index, 1991=100).∗

Source: our elaboration on OECD.Stat, Economic Outlook No 102 - November 2017. ∗ Total disbursement refers to current expenditure plus investment expenditure (gross of interest payments if not differently mentioned).

Source: https://www.ineteconomics.org/perspectives/blog/macroeconomics-and-the-italian-vote

Figure 1 Source: ECB Statistical Data Warehouse
Source: https://voxeu.org/article/japanese-frugality-versus-italian-profligacy
Six-Pack, Fiscal Compact & Two Pack 2011-13

• More restrictive conditions, for deficit countries
  • Adjusted deficit 0.5% of GDP
  • Absolute majority in Ecofin to reject the Commission’s prescriptions
  • European Semester
  • Macroeconomic Imbalance Procedure

• Increases the explicit control of supranational institutions on a pool of national practices, all while maintaining political exceptions
  • Two Pack, countries in the European Stability Mechanism are under special surveillance (until 75% of support has been repaid)
  • Countries whose difficulty could have “significant adverse effects” on the rest of the Union could be asked to implement adjustment programs
France and Germany to agree on a European Budget?

• Funding reforms in economies to boost their “competitiveness and convergence”.

• Under a new system, member states “would submit policy plans to the Commission that contain both their planned reforms and proposals for projects to be supported under the budgetary instrument”.

• Unspecified size
Banking Union

• First pillar: Single Supervisory Mechanism responsibility of the ECB
• Second pillar: Single Resolution Mechanism, a fund worth 55 billions euro (0.2% of total assets of the Euro area banking system)
  • The SRF is composed of contributions from credit institutions and certain investment firms in the 19 participating Member States within the Banking Union.
• Third pillar – still missing: deposit insurance scheme
• Bank Recovery and Resolution Directive (BRRD). Taxpayer-funded bailouts were supposed to be replaced with bail-in of equity and bondholders
• Criticism:
  • Risk of run on deposits
  • Fragmentation of the the banking market: turbulence can cause liquidity and solvency problems for solid banks as well.
Politics or Technocracy?

• Fiscal policy defines the relation between the state and the market and represents a mediation between social and economic claims.

• In the EU, that mediation is filtrated by the technical interpretation of the institutional structures both national and union-wide:
  • Techniques rather than providing ways to realize political preferences of a community, becomes an instrument to limit the options available to politics.

• But the presence of rules reveals that there is no hegemonic bloc.

• Dangerous economic alarmism, a wasted decade (more?) and uncertain outcome.