After the Stability Pact

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The Stability Pact agreed to 1997 is dead and gone. The European Commission's decision last week to delay in proceeding with sanctions against Germany for exceeding the 3 per cent limit on budget deficits for a third straight year has driven a stake through its heart.

It is tempting to see this as good news. The case for rigid ceilings on budget deficits was never particularly compelling. The idea that the ECB would run an inflationary monetary policy if Germany's budget deficit was 4 per cent rather than 3 per cent was never plausible. And now that there are no national monetary policies to be tailored to French or German economic conditions, the importance of a flexible fiscal policy that can respond to the state of demand is greater still.

This is why Germany is now in breach. GDP growth will be a cumulative 2 per cent less in 2003 and 2004 than forecast a year ago when the government formulated its plan to bring the deficit into compliance with the Pact. Given the unexpectedly weak state of demand and the reluctance of the ECB to cut interest rates given stronger growth elsewhere in the euro zone, a larger deficit is desirable. To cut spending now would weaken demand still further. It would be destabilizing for the economy.

Does this mean that there is no remaining role for EU surveillance of national fiscal policies? To the contrary, the demise of the Stability Pact should be seen as an opportunity to strengthen multilateral surveillance. The Commission should focus not on arbitrary 3 per cent "reference values" for deficits that have no basis in economic logic but on the fundamental challenges for fiscal sustainability in Europe. These are ageing populations that imply increased spending on public pensions down the road. They are health care expenditures that threaten to spiral out of control. They are opaque budgetary data in countries like Portugal that make it hard to identify fiscal excesses and correct them before they get out of hand.

These are the fundamental problems with fiscal policy in Europe. The Commission is of course aware of them. But because its credibility and good name have been hitched to a 3 per cent deficit ceiling that is at best silly and at worst perverse, its recommendations for addressing these more fundamental issues are disregarded as soon as they are issued.

Europe should acknowledge that the 3 per cent limit on deficits is defunct and that the notion of sanctions and fines for violators is a mirage. But it should take this as an opportunity to focus on the fiscal issues that really matter. The Commission, if it stops paying lip service to the Pact's non-workable 3 per cent ceilings, can take the lead in this reorientation.

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