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To the point!

Cross-Asset- and Strategy-Research

Old wine in new skins

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The latest proposal to overhaul the Stability and Growth Pact (SGP)

The Stability and Growth Pact (SGP) was created to ensure all member countries of the Euro area follow a path of sustainable public finances. Macro stability in a monetary union constitutes a public good. Each and every member country is to contribute to a solid environment of public finances. Free-riding prohibited!

The Stability Pact did not bring stability (or growth)

Breaking the rules has been the rule, not the exception

The hope that the SGP would weld together all EMU member countries into an unflinching stability community turned out to be an illusion. This had become apparent well before Greece and Cyprus crashed into default. For example, in both France and Portugal, the public sector printed deficits above the maximum limit of 3% of GDP in three quarters of all years. Not to speak of Greece. Even Germany posted excessive deficits in one year out of three (see chart). Between 2001 and 2019, eight EMU member countries recorded an average annual deficit in excess of 3%, including such heavyweights as France, Italy, and Spain. All added up, the deficit limit was breached no less than 130 times! Since the pandemic the SGP has been suspended altogether.

The targets of the Pact have been missed

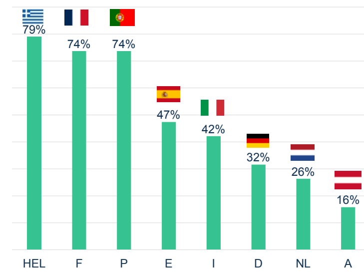
The targets laid out in the Pact were thus badly missed. The fact that the Pact was overhauled several times, so as to make it „more intelligent“ did not help. Those consecutive reforms had made the rules ever more complicated and added loopholes. It also made it more political in its application.

If at first you don’t succeed: yet another reform proposal…

Brussels is not one for easily throwing in the towel and declaring defeat. On Wednesday, the EU Commission published a new proposal on how to revitalize the Pact. The upper limits cited by many critics, 3% of GDP for public deficits and 60% for debt, were left intact. After all, these benchmarks rest on the EU treaties. They can only be modified if a broad consensus were to exist across member states. Which is unlikely.

Instead, the Commission proposes measures to assist budgetary sinners on their respective paths to fiscal soundness. It is good to abandon prescribed adjustment paths that are utterly unrealistic. It is also to be welcomed that governments are encouraged to take more structural fiscal adjustments rather than the hitherto prevailing short-term band aids. Yet, it is not immediately clear why this would not – once again – open the door to more lenience in its application.

Percentage of years in which member states breached the 3% of GDP deficit limit (2001-2019)



Source: AMECO online, LBBW Research

The core of the problem: a lack of political will

The SGP fundamental problems are neither the limits nor the adjustment paths of particular financial programs. More fundamentally its effectiveness suffers from the lack of political will to crack down on breaches of the rules. Up till now, the EU Commission had initiated 38 deficit-related procedures. How many of those led to actual sanctions, however mild? Zero!

Changing operational details will not solve the fundamental problem

The Commission proposal fails to address the fundamental problem: heads of states and governments will simply not sanction each other. What is missing is an independent fiscal council consisting of experts, in charge of enforcing the agreed fiscal adjustment and decide on imposing sanctions on persistent violators.

Central banks are purposefully put beyond arm's length of politicians to facilitate an unbiased conduct of monetary policy. To allow for an unbiased application of the SGP, proposing an analogous institutional set-up would have been useful. Removing the power of governments to protect each other was apparently one step to far for the Commission