The European Stability Pact and Feedback Policy Effects

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Abstract

With a two-country dynamic model in a monetary union with wealth private behaviors, we study the implications of public debt on monetary and fiscal policies. The model used has Keynesian features in the short run and Wicksellian ones in the long run. We analyse the effects of asymmetric fiscal policies in Euroland and show that such a situation creates two feedback effects which reduce the efficiency of economic policies. First, because of the inability of one government to implement an expansionary fiscal policy, the other government has to substitute for it to reach economic targets. Second, the ECB’s involvement in macroeconomic stabilisation will be exacerbated. The more substantial these effects, the more coordination is needed between European governments and the ECB.

• JEL Classifications: E17, E63, H63
• Key Words: EMU, Stability and Growth Pact, Monetary Policy, Fiscal Policy, Public Debt.

I. Introduction: the European Institutional Framework

The advent of the European monetary union, now called Euroland, accelerated following the Maastricht treaty (December 1991). Most institutional dispositions for the EMU in fact ensue from this treaty and have then been completed by the Stability and Growth Pact (Amsterdam Council, June 1997, clarified during the Luxemburg Council, December 1997). These dispositions are being applied since
the 1st January of 1999.

Eleven countries from the European Union (EU) first joined the Euroland; they were caught up by Greece on the 1st January of 2001. At first sight, the size of this new monetary zone, which includes some of the bigger ones (except the UK) and many small ones (Ireland, Spain, Portugal...), may incorporate much heterogeneity from one country to the other, despite the urge for a high degree of prior nominal economic convergence as a precondition for the entry into the Euroland¹. Competitiveness, the degree of openness, the industrial and trade structures, even the unemployment rate, are among these notorious heterogeneous components. They may therefore necessitate the implementation of differentiated domestic policies.

Monetary policy in the Euroland is however “unique” and assigned to a nominal target. The European common monetary policy is implemented by the European System of Central Banks (ESCB), made up of the very centralised European Central Bank (ECB) and domestic central banks of the Euroland. Its main objective is “to ensure price stability” (Maastricht tr., art. 105). The ECB and domestic central banks are independent from national governments as well as from the European Commission (EC)² (Maastricht tr., art. 107). It follows that central banks cannot monetise public debt, and buy or sell Treasury bills or bonds (Maastricht tr., art. 104).

In contrast, fiscal policies are still in the hands of national governments – fiscal federalism or coinsurance³ have not yet been improved – and their sole instrument for coordination is comprised into the Broad Economic Policy Guidelines (BEPG) which only consist in the preparation by the EC of non binding recommendations on economic policy and economic reforms, adopted by the ECOFIN Council⁴.

Coordination of fiscal policies among EU countries has been reinforced by the creation of the Eurogroup (ECOFIN Council, October 1997). This institution, nonetheless, has no binding power: it has to improve the exchange of informations between countries regarding their economic overall situation; it has to monitor these situations and their incidence on public finances; finally, it has to control for the evolution of labor market reforms. This informal-type of coordination seems

¹The rationale for “convergence criteria” is dealt with, for instance, in Gros & Thygesen (1992).
²The Commission is independent from the member states of the EU; its prerogatives are to represent the common interest of EU countries, to make propositions to the Council (which embodies the representation of national governments), and to implement the decisions which are taken by the Council.
³Cf. Eichengreen (1993) for a presentation of the main arguments on this topic.
⁴i.e. regular meetings of the Ministries of Finance of the EU countries.