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Criteria for Excessive Public Sector Deficits in Stage Three of EMU

(Monetary Committee Alternates Meeting 15th November)

I attach a Report of the meeting in Brussels. A medium length summary is included, together with additional detail on some points.

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Criteria for Excessive Public Sector Deficits in Stage Three of EMU

Summary

1. The Monetary Committee Alternates met on 15th November to discuss their mandate from the plenary Committee to examine whether or not additional precision could be placed on the criterion of an "excessive" budget deficit in full Economic and Monetary Union, given that[1]:

- "budgetary discipline is of paramount importance for achieving the objective of price stability" and that:
- "A stability-orientated monetary policy can in the long run only be successful if supported by sound budgetary policy, and any departure from this by a member state could create difficulties for the whole Community".

Discussion centred on the possibility of deriving quantitative indicators that could be used as "triggers" for a full examination of a country's budgetary position, initially by the Monetary Committee and if necessary by ECOFIN. At the latter stage the controversial issue arises of the Council being empowered to take legally binding Decisions by a majority vote, and where the Decisions could be enforced by penalties.

2. Delegates agreed with the French suggestion that in the full EMU environment of no monetary financing of the public sector and no bail out[2], the search was initially, for indicators that could identify budget deficits that posed a risk of instability or default (and hence threatened the no monetary financing and bail out clauses), and secondly, for deficits that posed a threat to monetary stability. Other aspects of fiscal policy, for example relating to the optimal policy mix, were not relevant to this question and should be covered in the multilateral surveillance exercise.

3. After a difficult debate, the Chairman (Stek: Netherlands Ministry of Finance) observed that some progress had been made, and that a majority

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1 Quotes from: "Economic and Monetary Union Beyond Stage One", Report by the Monetary Committee.

2 Transitional arrangements for progress towards EMU were not part of the mandate.

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of countries (eight)[3] were in favour of introducing a system of quantified thresholds. If these were breached they would trigger a full study of a country's fiscal position, although there could be no presumption that this examination automatically implied a problem. A minority (the United Kingdom, Spain and Denmark) expressed reservations about this approach, suggesting that simple indicators would not be able to adequately capture the complexity of the public financing process and its interaction with monetary policy and macro-economic developments. Instead these countries preferred a more judgmental framework.

4. There was only a very general agreement on the indicators to be studied further by the Commission in simulation form. The majority of delegates in favour of the benchmark approach supported simple indicators as these would be most easily understood by politicians and the general public, and were in any case only providing an initial screening. Others, particularly the Italians and the Portuguese representative, argued that this screening needed to be as accurate as possible to avoid both wasting time and political embarrassment, and hence if complexity was needed (as it was in their view), then so be it.

5. With this proviso it was agreed to examine further the following three (or two) possible criteria. A deficit would be regarded as sustainable if:

(a) The public sector debt/GDP ratio was less than a certain level (either an absolute number or perhaps some multiple of the Community average) and/or the current years' primary balance[4] reduces the difference between the previous years' actual and stabilising primary balance[5] by a certain proportion (for example 50%).

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3 The Luxembourg position was unclear.

4 The government borrowing requirement excluding interest payments.

5 The stabilising primary balance is the primary balance necessary to stabilise the debt GDP ratio. The difference between the actual primary balance and the stabilising primary balance is known as the primary gap.

(b) The "Golden rule" of public finance holds. This states that government net borrowing should not exceed its capital expenditure[6].

(c) The actual budget deficit (in relation to GDP) was less than a certain level.

Some were only prepared to support the amalgamation of the latter criteria i.e. a deficit would be excessive only if the actual deficit was above a certain level without respecting the Golden rule.

6. It was agreed that other indicators could provide valuable supplementary information in a full examination, and that it would be useful to discuss these at greater length in the future. Among those put forward as candidates were:

(d) Indicators of excess demand, although some felt these were more relevant to the question of the optimal policy mix.

(e) The relationship between the public sector deficit and savings in each national economy, although others argued that this was irrelevant and against the spirit of Economic Union.

(f) The duration (average maturity) of debt.

(g) Ratings by the market, for example utilising yield differences on government bonds.

(h) Perhaps country-specific indicators.

7. A whole raft of practical difficulties were raised during the meeting which remain to be solved at some future date. These include:

(i) The definition of the public sector (there was a majority but no unanimity on the general government definition[7]). Should this be on a cash or a transactions basis?

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6 The motivation of the Golden rule is that it preserves the net worth of the public sector, as the return on the investment can in theory be used to service the interest payments on the borrowing.

7 Although there was no discussion on whether this should be the historic national accounts general government definition or the EUROSTAT ESA (European System of Integrated Economic Accounts) definition which excludes the trading activities of government departments.

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(j) Whether to focus on net or gross public sector debt (and net or gross investment in the Golden rule context) and the associated measurement problems. For example, how should human capital be treated?

(k) How many years should the appropriate medium-term framework cover. Three, as many suggested, or more as did others?

(l) Who should undertake the necessary forecasting? Does this need to be undertaken centrally, as the Italians argued, to avoid political bias?

(m) How should contingent liabilities be treated such as state guarantees or unfunded public sector pension schemes?

(n) Can trigger points be chosen sufficiently accurately to avoid missing early warning signs of excessive deficits, whilst at the same time avoiding too many false signals i.e. identifying deficit "problems" that with deeper analysis do not prove to be excessive?

(o) What allowance should be made for different starting points and the different structure and role of the public sector in the Community countries.

8. The Chairman agreed to draft a summary of the meeting for the Monetary Committee, noting the possibility of making further progress, but also emphasising the reservations of some delegates.
He hoped to get a mandate for the Alternates to carry on with the work.

Further Detail on Some Points

9. Stek noted that the purpose of the meeting was to ascertain whether or not analytical content could be given to the notion of an "excessive" budget deficit, which has at present only been defined in very general terms in the Monetary Committee paper on "Economic and Monetary Union beyond Stage One"[8]. He emphasised that he wished to avoid the major political issues such as "binding rules" versus "discretion" and the question of what, if anything, should be drafted in the Treaty. He was only partially successful in the latter aim as the issue bubbled under the surface and clearly coloured national interventions. Delegates were thanked

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8 See paragraphs 6 to 8 of the Monetary Committee paper.

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for their written contributions which had been sent in and the Secretariat and Commission were commended for their papers[9].

10. Samuel-Lajeunesse (Tresor France) helpfully identified the parameters of the study, emphasising that the analysis was based on a Stage Three environment where monetary financing of the public sector and bail-outs of national governments by the Community were ruled out by definition. Consequently he felt that the focus should be firstly on indicators which might signify signs of possible default or an unsustainable public sector debt burden, as this would threaten the credibility of the no money financing and no bail out clauses. A second and somewhat less important issue was to judge when a public sector deficit jeopardised monetary stability. This was accepted as a useful basis for discussion.

11. Delegates were split on the value of quantified indicators to assist in the identification of an excessive deficit. The German representatives argued forcefully that although it would be necessary to apply judgement in the limit, they were nevertheless strongly of the opinion that objective "warning lights" were valuable to avoid the exercise degenerating into something that was excessively ad hoc and imprecise. The majority of the other delegates supported this view, providing that there was no presumption that a threshold being surpassed put the onus of adjustment or guilt on a country, and that it simply represented the call for a fuller analysis.

12. The issue of how accurate an indicator should be was debated at length. Several countries (Germany, France, Ireland, the Netherlands, Greece and Belgium) argued in favour of simple measures that could be easily understood (although they did not agree between themselves on what these measures should be, with for example, the Germans favouring the Golden rule despite its acknowledged difficulties, whilst the French were unpersuaded). Others, particularly Italy and to a lesser extent Portugal, favoured accuracy even if that meant complexity. Ghisellini (Italian Minister of Finance) noted that politicians and members of the Monetary Committee would not welcome indicators that proved to be unreliable, and pointed out that there could be a negative impact on markets if it became public knowledge that countries were being examined, particularly if that

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9 I have a full set of the documents.

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implied any guilt. Riley (U.K. Treasury) seized on this argument to support his view that triggers were dangerous and of little value and that the issue of whether or not a deficit was excessive was complex. Others agreed that the question was complex and needed a full assessment to give a more precise answer, but only the delegates from Spain and Denmark agreed with Riley's corollary that because of this, there was little value in the preliminary screening phase.

13. There was some agreement on indicators of possible debt unsustainability. Most delegates were willing to use the concept of the "primary gap" in some form or another, although some felt that it was a little complex. The Commission proposal to use the speed of closure of the primary gap (tentatively suggested at a pace of 50% a year) in conjunction with an indicator of the debt burden (debt/GDP) won a favourable response, and the staff were requested to undertake additional simulation work on this measure.

14. Less progress was made on indicators of budgetary performance which might imply an adverse interaction with monetary policy. Duran (Banco de España), in particular, stressed the inherent difficulty of this task and felt that it would not be practical or sensible to use a trigger in this area. Some others felt that he was too pessimistic and put forward a variety of indicators. The "Golden rule" as an indicator of the "quality" of a deficit had many supporters on the grounds of simplicity, although the Italians and French considered that the acknowledged technical and measurement deficiencies were strong. Nevertheless the Italians were prepared to accept it when combined with an indicator of the "quantity" of a deficit as many suggested (such as the actual budget deficit - perhaps adjusted for cyclical developments), but they would not support use of the two individually, as this would give each criterion too much weight. Future Commission simulations will reveal whether or not delegates feel that this combined criterion is workable.

15. The use of Community averages as "norms", as suggested for example, in the papers by the Commission and the German delegates, was strongly criticised by many delegates. Riley noted that Community averages were likely to be "too high to be optimal and too low to be excessive", whilst Gaspar (Ministry of Finance Portugal) added that averages paid no attention to important national characteristics. "Why should the Portuguese Debt/GNP ratio be the same as Germany or Greece?".

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Future Steps

16. Stek intends to report to the full Monetary Committee in late November that the majority of Alternates believe that some progress can be made, although the reservations of the minority will be given their due weight. He hopes to extend the Alternates mandate to study the topic in greater depth with the aid of the simulation work by the Commission. It is likely that the Alternates will meet again to discuss the subject early in the New Year. There remains considerable ground to cover.

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