How Important are the Fiscal Policy Convergence Criteria?

The closer the date on which a decision on participation in European Monetary Union is to be taken approaches, the more pressing is the question as to the rationality of the fiscal policy convergence criteria. This is all the more so in view of the substantial deterioration in the economic situation throughout Europe, which means that even Germany is experiencing difficulties in meeting the fiscal policy convergence criteria set out in the Maastricht Treaty. Last year Germany's budget deficit accounted for 3.5% of GDP, and was thus in excess of the 3% reference value which, according to the Treaty, may only be exceeded "exceptionally and temporarily". In 1996, too, the deficit will be in excess of the reference value.[1] If this is again the case in 1997, the question must be addressed as to the consequences for the implementation of the Treaty. It seems likely that the calls will mount for the introduction of monetary union to be postponed.

Such a postponement would be a risky undertaking, however, as it might well undermine the willingness of a number of EU Member States to continue to lend their support to the process of convergence. If, namely, participation in monetary union recedes into the distance, governments will find it increasingly difficult to resist the pressure put up by those seeking to return to a strategy more closely oriented to domestic concerns. If this were to lead to turbulence on the currency markets, even the present state of the integration process could be endangered. It is for this reason that the leading German economic research institutes, in the their autumn report, advised strongly against postponing the introduction of monetary union, drawing attention to the fact that the pressure inherent in the tight schedule decided at Maastricht and confirmed at Cannes is necessary to prevent the convergence process degenerating into a divergence process.[2]

This served to underline the importance of the convergence criteria in their entirety. Yet the relationship between the various criteria and the weight to be accorded to each are very different questions. The Maastricht Treaty lists five criteria in all, two of which relate to fiscal policy, with three closely related to monetary policy. The discussion on the fiscal policy criteria is increasingly driving the fact out of public consciousness that the Treaty also demands a convergence of inflation and long-term interest rates and "tension-free" participation in the exchange rate mechanism of the European Monetary System. The relationship between the two groups of criteria is largely undetermined. Are they essentially independent of one another and can each be met on its own? Or does adherence to the monetary policy criteria presuppose that the fiscal policy criteria are met?

Yet there is a third possibility: adherence to the monetary convergence criteria could make it more difficult to meet, or even prevent countries fulfilling, the fiscal policy criteria. If this were the case, economic policy makers would be forced to set priorities; they would have to decide which set of convergence criteria was to be accorded preference. This means, however, that they would have to be prepared to resort to the "exception clauses" contained in the Treaty. Although this would not seem to require a modification to the wording of the Treaty, there can be no doubt that such a decision would exert a decisive influence on the success or failure of monetary union. In view of this it is necessary to look carefully at the relationship between the fiscal policy and the monetary criteria.

From fiscal policy to monetary convergence?

The Treaty of Maastricht juxtaposes the convergence criteria without making any attempt to rank them. Although this may be legitimate in drawing up a Treaty, it does not release economic policy makers from the obligation to priorities specific areas as it sees fit. Indeed, such emphases are unavoidable. It has been repeatedly argued that a sharp rise in government deficits generates inflationary expectations, pushes up interest rates and destabilises exchange rate parities. This line of argument was again put forward when, in February of last year, the dollar began to slide, dragging down with it a number of European currencies. Budget deficits, it was claimed, are particularly destabilising when the recent history of the country affected by currency depreciation fails to create the impression of consistent fiscal policy "solidity", awakening fears that this might well also be the case in future.

If this argument is correct, fiscal policy solidity is a necessary, albeit not a sufficient, condition for monetary stability. Consequently, the emphasis should be on meet-

[1] Cf. Economic trends. In: *Economic Bulletin,* vol. 33, no. 1, January 1996.

[2] Cf. The World Economy and the German Economy in the Autumn of 1995. In: *Economic Bulletin,* vol. 32, no. 11, November 1995.

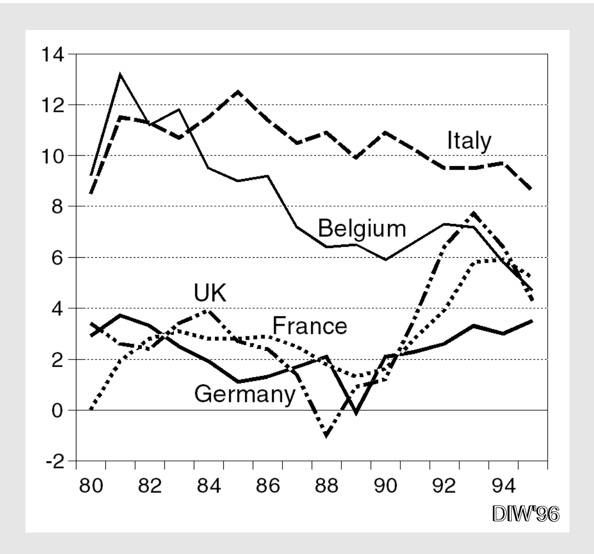
ing the fiscal policy convergence criteria: not only on the budget deficit as a share of GDP, which indicates the course currently pursued by fiscal policy, but also on government debt as a share of GDP, which gives an insight into a country's fiscal policy "history". Seen in this light, the impression given by the member countries as regards convergence is not particularly favourable. Figure 1 shows the deficit-to-GDP ratios of a number of leading potential participant countries. At the start of the 1990s the figures for France, Great Britain and Germany were very divergent. This largely reflected the asynchronous course of the national business cycles: whereas the global economy had entered into a deep recession, the German economy was benefiting from the economic boom that followed unification. As output stagnated, tax revenues in Germany's partner countries declined for cyclical reasons, leading to a sharp rise in the deficit-to-output ratio. In spite of rising output in Germany, its deficit also rose as a share of GDP because the unification boom had been initiated by government deficit spending; but here rising tax revenues due to the expanding economy ensured that the increase in the deficit as a share of output was far less pronounced than in the other countries. More convergent deficit trends were not achieved until cyclical developments once again became synchronic: the 1994 upturn marked a return to a convergent trend. More recently, however, this trend towards convergence has once again been called into question.

Nor does the ratio of government debt to GDP over time present a particularly encouraging picture (cf. figure 2). Outstanding government debt has increased as a share of output in most countries, more so in some countries (e.g. Italy), less so in others (e.g. France). In Great Britain, on the other hand, the figure actually declined over some of the period, a result of a combination of strong growth between 1987 and 1990 and wide-ranging privatisation measures.[3] Yet here, too, outstanding government debt has recently risen perceptibly as a share of output, in which deficit spending in the recession at the start of the 1990s played a not inconsiderable role.

Once government debt is significantly above the Maastricht ceiling (60% of nominal GDP), it is far more difficult to bring it down to the reference value than is the case with an "excessive" deficit-to-output ratio (reference value: 3% of nominal GDP). Government may not, after all, take on new debts in order to pay off outstanding debts, but must ensure that fiscal income exceeds public spending. However, if governments were to seek to replace permanent deficits with fiscal surpluses within a short space of time, this would not only have highly undesirable consequences for the economy, but would also have unfavourable feedback effects on public budgets themselves.

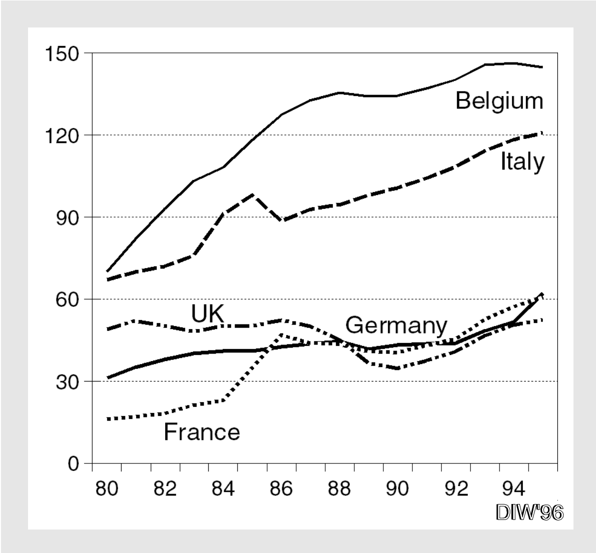
This is because net government liabilities are matched by net claims by the other sectors. If govern-

Figure 1
Budget Deficit as a % of GDP



Sources: OECD, Economic Outlook; DIW calculations.

Figure 2
Government Debt as a % of GDP



Sources: OECD, Economic Outlook; DIW calculations.

[3] Privatisation measures are counted when calculating the debt-to-GDP ratio but not in determining the deficit. Given the fact that substantial privatisation occurred in a number of other EU countries during the 1980s, the scope for generating additional revenue in future is likely to be limited.

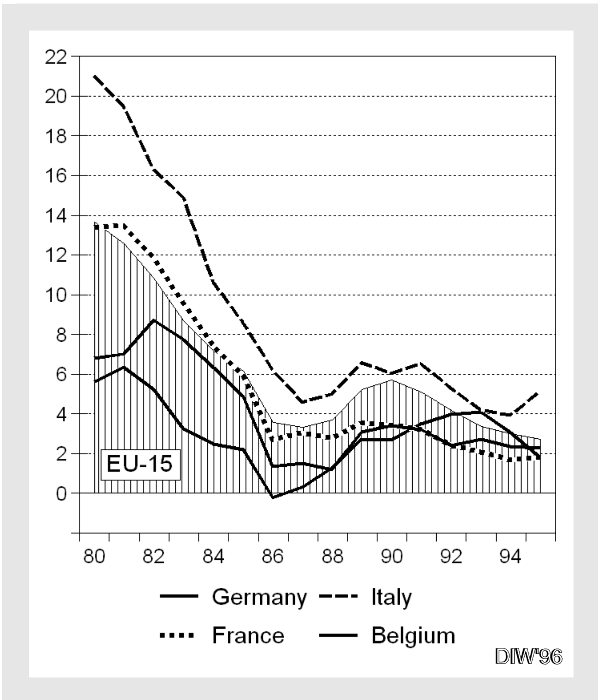
ment wishes to reduce its level of debt, the rest of the world, private households and firms must, as a whole, accept financial deficits. Yet any rapid reduction in the volume of outstanding government debt would have a serious impact on economic development. This would take the form of a negative demand shock which households and firms would not be able to absorb without negative consequences. Households would be forced not only to completely stop saving, but would be forced to "dissave", i.e. to reduce their stocks of financial assets. If households fail to respond to the "consolidation shock", it will hit either the corporate sector or the rest of the world. If domestic firms find themselves confronted with a sudden fail in public demand, without any compensation in the form of lower saving by private households or the rest of the world, cuts in output are sooner or later inevitable.[4]

Even if the cost of reducing the level of outstanding government debt were primarily borne by the rest of the world, domestic economic developments would still suffer negative feedback effects. Given that the "rest of the world" also consists of governments, firms and private households, the question is again which sector is to bear the burden of adjustment. Here, too, it is private firms that would suffer most if government started to run budget surpluses. If all members of the European Union were to pursue such a strategy, the only "buffer" left is the non- European rest of the world. Given that Europe's trade with the rest of the world accounts for a comparatively small share of its overall trade, the attempt by EU Member States to consolidate their public finances would primarily be felt within Europe itself: growth and employment losses would be the inevitable consequence.

The same applies even if it not outstanding government debt, but "merely" the current deficit that is to be reduced. Although firms need not necessarily face losses in such a case, the policy change would certainly squeeze profits. This would clearly undermine the efforts currently being made to ease the fiscal burden on firms (reducing indirect wage costs and marginal tax rates). Such a policy effectively saws away at the branch on which it is sitting, creating conditions that are precisely such as to prevent an improvement in corporate profitability. It is thus difficult to see how such an approach can serve to bolster the confidence of financial market. The opposite is more likely to be the case: a policy that increases the burden on firms, that weakens economic growth and creates unemployment, is not sustainable in the longer term. If the financial markets anticipate such a development, there is the danger of turbulence on the foreign exchange markets in the run-up to monetary union. This would not only endanger conformity with the exchange rate criterion, long-term interest rates could drift apart once more as investors will demand higher risk premiums for securities denominated in currencies thought to be at risk of depreciation.

This, however, would place a question mark over the very success in terms of economic convergence that was achieved in the 1980s and early 1990s. Figure 3 shows that since the start of the 1980s inflation has been substantially reduced and steadily brought close to German standards. Given that the exchange rate risk, although not fully removed, has been substantially reduced, long-term interest rates have also converged (cf. figure 4). It is not just that these successes in terms of economic convergence have increasingly been forgotten in the current discussion: they are in stark contrast to the comparatively small degree of convergence achieved in the area of fiscal policy. Thus the hypothesis that a consolidation of government budgets is a necessary precondition for monetary stability cannot be sustained in the form propounded. Indeed, one can go a step further and ask whether the convergence-related successes achieved in the monetary sphere were not necessarily to the detriment of fiscal policy convergence.

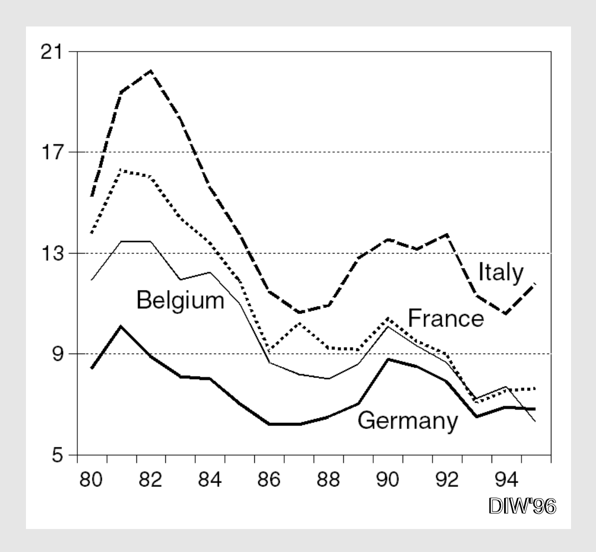
Figure 3
Consumer Price Inflation
Change in %



Sources: OECD, Economic Outlook; DIW calculations.

[4] Unless firms were themselves able to compensate for this fall in demand by increasing their own spending, i.e. demanding more investment and consumer goods.

Figure 4
Long-term Interest Rates, 1980 to 1995
% yield on 10-year government securities



Sources: OECD, Economic Outlook; DIW calculations.

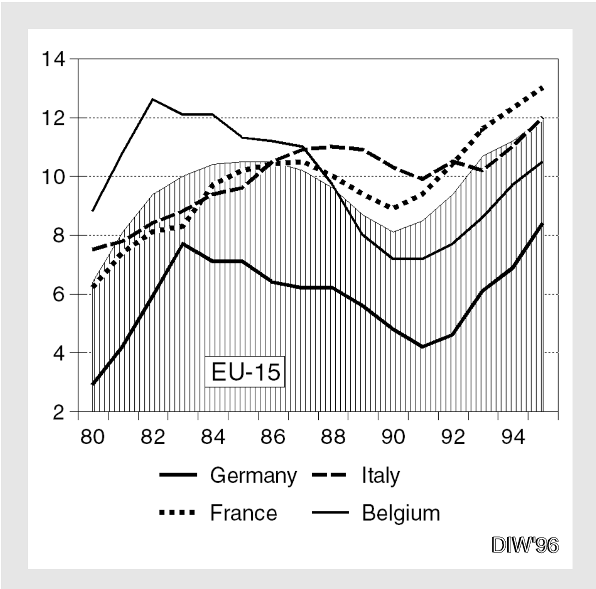
Monetary convergence and its costs

Whereas the public discussion on the Maastricht Treaty is increasingly dominated by the question as to the steps that need to be taken to fulfil the fiscal policy convergence criteria, the accent during the 1980s and early 1990s was clearly on the fight against inflation. The central concern in this regard was that divergent inflationary expectations could be carried over into monetary union, where they would exert a destabilising effect. If, following the transition to a common currency, inflationary pressure were to build up, a European Central Bank would have to face up to the question of whether to accept it or to fight inflation by raising interest rates. The first option would involve rates of inflation that are unacceptable from a German perspective; the second would inveolve a continuing rise in unemployment, which many of Germany's partners would find difficult to accept. A conflict of aims would thus be inevitable. Even if generalised inflation could be avoided, sharp regional labour market disparities might occur, generating a need for increased intra-European transfer payments.

Thus there was effectively no alternative to an equalisation of inflation rates. In order to bring about the change in course required, credible signals had to be sent to market actors that they could no longer count on an accommodating monetary stance and that absolute priority was to be accorded to bringing down inflation. A mere declaration of intent would not have sufficed, what was required was a binding commitment which made it clear to all those concerned that the monetary authorities were steadfast in their determination to break inflationary expectations. A central role in all this was played by the exchange rate mechanism of the EMS, participation in which was linked to the commitment to stabilise the exchange rate against the D-Mark within an intervention band of +/– 2.25%. This commitment could only be honoured if the central bank of each participant country more or less accepted the monetary policy pursued by the lead-currency country. This meant that national central banks were prepared to follow the decisions taken by the German Bundesbank on interest rate changes even if this had negative consequences for domestic growth and employment.

This is precisely what occurred in a number of countries. Figure 5 shows that unemployment rose particularly rapidly in those countries that made great efforts to reduce their inflation rates and to swiftly bring it in line with German standards. Two factors played a particularly important role in this context. Firstly, the attempt to stabilise nominal exchange rates, particularly in the phase 1987 to 1992, led to the real appreciation of the currencies of those countries whose inflation rates had been substantially higher than in Germany following the second oil-price shock in the early 1980s. This real appreciation seriously exacerbated the competitive pressure to which firms in the convergence countries were in any case exposed due to the increasingly highly integrated goods and financial markets.

Figure 5
Standardised Unemployment Rate
in %



Sources: OECD, Economic Outlook; DIW calculations.

Restrictive effects also emanated from monetary policy. This was revealed particularly starkly by German unification. While the German Bundesbank was steadily raising interest rates in order to break the inflationary expectations that had arisen in the course of the unification boom, Germany's European partners remained locked in recession. Despite this they were forced to follow the interest rate policy of the Bundesbank and raise their base rates, although the cyclical state of their economies demanded precisely the opposite. The upshot of this was that the long-term interest rate, although easing globally since 1991, was only able to fall to a far lesser extent than would otherwise have been the case.

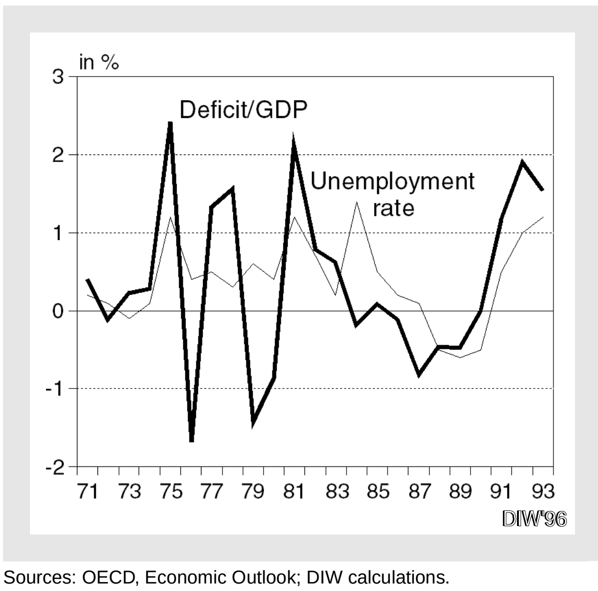
Back in the 1980s interest rate trends on the capital market had also exerted a restrictive impact. Although participant countries managed, by virtue of a strategy of exchange rate stabilisation, to reduce the rate of inflation, and thus to make adjustments in exchange rate parities less likely, a small risk remained which, it seems, was sufficient to prevent complete convergence of long-term interest rates. This meant that the capital market rate in Germany's partner countries was determined by the German capital market rate plus a risk premium. Thus even if the capital market rate in Germany had been consistently appropriate to each and every economic situation, the rate in Germany's partner countries would, on average, have exerted a restrictive effect. This restrictive effect was, of course, desirable in economic policy terms, because the very apparent willingness of the monetary authorities to accept high and even rising mass unemployment signalled to market actors that monetary policy would remain "tough" and would under no circumstances accommodate wage increases incompatible with price stability.

Just how fragile this monetary and exchange rate policy constellation in fact had been was clearly revealed once the Maastricht Treaty imposed additional conditions on participation in European Monetary Union. This increased the probability that various countries would fail to stick to the convergence process and would return to a strategy more clearly oriented towards domestic concerns. Although even in the 1980s national fiscal policies were consistently based on the aim of fiscal consolidation, policy makers were still prepared to accept cyclically induced deficits. Taking changes in the unemployment rate as an indicator of cyclical developments, changes in the budget deficit as a share of output followed a broadly similar pattern in both Germany and France, as can be seen from Figures 6 and 7. Clearly, in spite of all the attempts at fiscal policy consolidation, cyclically induced deficits were tolerated during this period. Not until the Maastricht Treaty, with its explicit demand for a reduction in budget deficits, placed a question mark over the use of these built-in stabilisers did the currencies of those countries come under pressure that had not previously been struggling with the consequences of real appreciation. In September 1992 sustained waves of speculation occurred which forced an adjustment of central exchange rates for the first time since 1987. In August 1993 the EMS was effectively suspended; the intervention bands were drastically widened. Thus the very instrument that since the start of the 1980s had made the greatest single contribution to monetary convergence in Europe was relinquished.

In view of this it is very doubtful whether it would have been possible to achieve convergence of national inflation rates if Germany had insisted on a massive reduction in not only the budget deficits but also outstanding government debt as a share of GDP back in the early 1980s. A "double burden" of monetary and fiscal convergence would have placed even greater pressure on the European exchange rate system than was actually the case in the wake of the harmonisation of monetary policies. Under such circumstances national monetary authorities would scarcely have been able to stabilise exchange rate parities over a period of five years. Turbulence on the foreign exchange markets would undoubtedly have put a swift end to the vision of a common currency. Thus fiscal policy convergence was substituted for monetary policy convergence in order to establish the elementary precondition for a common currency: price stability.

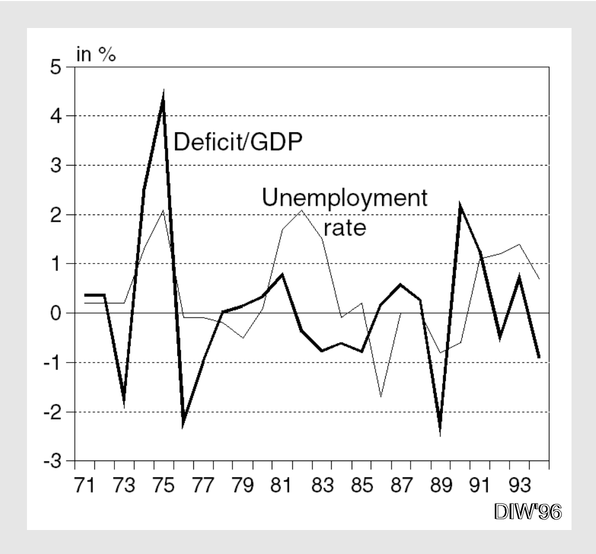
Figure 6

Changes in the Deficit as a % of GDP and the Unemployment Rate in France



Sources: OECD, Economic Outlook; DIW calculations.

Figure 7
Changes in the Deficit as a % of GDP
and the Unemployment Rate in Germany



Sources: OECD, Economic Outlook; DIW calculations.

Consequences for economic policy

The attempt to meet both sets of convergence criteria in a phase of economic weakness is tantamount to squaring the circle. Both the monetary and the fiscal policy criteria can only be met if the monetary authorities in Europe as a whole ensure an adequate rate of economic growth. If this is not the case and if the emphasis is placed on meeting the monetary convergence criteria, it is virtually impossible simultaneously to fulfil the fiscal policy criteria. Either the monetary authorities explicitly take on the task of providing massive support for promoting economic development, or there is no alternative to prioritising the criteria. Are the fiscal policy criteria really so important that policy makers are justified in putting the success already achieved in terms of monetary convergence in jeopardy?

In principle the rationale behind the fiscal policy convergence criteria is simple. The restrictions on public deficits are intended to avert the danger of the European Central Bank coming under political pressure. Although the Maastricht Treaty prevents governments directly financing deficits by means of the central bank, indirect financing is always possible: the government issues bonds that are purchased by commercial banks, the acquisition of which is then refinanced through the central bank. This is not per se problematic, at least for as long as the overall supply of money expands at a rate in line with the rate of growth of potential output. What is decisive is how much money is brought into circulation, and not who gets it first the state or the banks. Public spending financed by the central bank does become problematic, however, when the central bank is put under pressure by government to make more liquidity available than is compatible with inflation-free growth, and the central bank succumbs to such pressure.

The thinking behind the debt criteria is similar. Clearly, the government debt accrued over past years no longer has any direct relevance to the present day, because the cyclical impact of fiscal policy depends on the incidence of current deficits and surpluses. The extent of outstanding government debt is of indirect relevance, however, because a heavy debt burden restricts the scope for fiscal policy action, particularly at times when the central bank is pursuing a restrictive course, pushing up the burden of interest payments on the public debt. Even allowing for the fact that the central bank's profits are then higher than before, it is indeed conceivable that in such a situation government might bring pressure to bear on the central bank to postpone interest rate hikes.

Thus the fiscal policy convergence criteria are not irrelevant.They constitute "supplementary insurance" against the abuse of a central bank that is formally independent, but in practice not necessarily completely so, for political ends.

What is decisive, however, is that the attempt to meet the fiscal policy criteria irrespective of the cost involves substantial risks for the process of European unification. These risks are likely to be far greater than those resulting from the application of the provisions for "exceptions" in the Treaty and those arising if countries that fulfil the monetary criteria, but face difficulties in meeting the fiscal policy criteria and may not be able to do so in 1997, the decisive year, are admitted to monetary union. If, namely, the reference values are to be achieved, fiscal policy makers in all the countries interested in participation would immediately have to adopt a massively restrictive policy stance, thus running the risk of weakening further the already fragile state of the European economy; this would serve, not least, to render the prospect of realising the deficit criteria itself a remote possibility. Moreover, if mass unemployment were to rise further, social and political tensions would result that could shatter monetary union and put back the unification process.

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