GLU

Global Labour Column

http://column.global-labour-university.org/

Number 25, June 2010

CSID
CORPORATE STRATEGY AND
INDUSTRIAL DEVELOPMENT

Why the Stability and Growth Pact does not work

by Till van Treeck

The current crisis of the Eurozone clearly shows that the European Stability and Growth Pact (SGP) does not work. A European "rescue plan" was finally agreed upon by the member states on May 9th 2010 after a long period of hesitation, especially in Germany. It has, for the time being, prevented the breakdown of the monetary union, as it could potentially grant up to €750 billion of credit to Euro countries with financing problems. But this rescue plan has merely bought time. The structural flaws of the SGP are still to be addressed.

The main problem with the SGP is that it focuses on the financial position of only one sector of the economy, namely the state. According to the SGP, no state should ever run a government deficit of more than 3% of GDP, with the further stipulation being a balanced budget over the medium term. Moreover, public debt shall not exceed 60% of GDP. The only legally binding constraint for any government is the excessive deficit procedure which will set in as the government deficit exceeds 3% of GDP. The two other important sectors of the economy, that is, the private and the foreign sectors, are ignored by the SGP.

Yet, it simply does not make sense to argue that a higher than 3% government deficit is unsustainable without looking at the financial balances of the private and foreign sectors of the economy. Remember that the financial balances of the three sectors necessarily sum to zero. This means that when one sector is running a deficit, then the remaining two sectors of the economy are running a joint surplus of exactly the same magnitude. If, for instance, the state runs a deficit of 2% of GDP and the private sector (households and companies combined) has a deficit of 10%, then the current account deficit of this country will be 12% (the financial balance of the rest of the world vis-à-vis this country will be 12%). Yet, such a scenario, which could hardly be considered sustainable, would not give rise to any sanctions within the current framework of the SGP. If, on the other hand, the private sector has a surplus of, say, 10% of GDP but the government runs a deficit of 3.5% (implying that the country has a current account surplus of 6.5%), then the government deficit will be considered too large and the country will face sanctions as defined by the excessive deficit procedure.

These scenarios are not merely hypothetical but of concrete empirical importance, as the following examples illustrate:

- Spain has never violated the 3% criterion of the SGP between 1999 and 2007. The public debt-to-GDP ratio decreased from 62% to 36%. The government even achieved surpluses in 2005-2007 of up to 2% of GDP. At the same time, the private sector was running huge and persistent deficits of up to 12% of GDP. As an implication of this, Spain was systematically running current account deficits of up to 10% of GDP.
- In Ireland the situation was quite similar. The public debt-to-GDP ratio decreased from 49% of GDP to 25% from 1999 to 2007, and the government almost always achieved surpluses (of up to 5% of GDP). At the same time, the financial balance of the private sector was systematically negative (up to -7% of GDP).
- By contrast, in Germany the government was in deficit from 2001 to 2006, and the 3% limit was violated during 2002-2005. From 1999 to 2007, the public debt-to-GDP ratio increased from 61 to 65%. At the same time, however, the private sector was persistently running surpluses, which always exceeded the government deficit, and at times were as large as 9% of GDP. This implies that Germany was persistently running a current account surplus, which increased up to almost 8% of GDP in 2007.

What do we learn from these examples? From 1999 (the year when the Euro was introduced) to 2007 (the year before the global crisis started), it seemed that public finances were more "solid" in Spain and Ireland than in Germany. Yet, in the course of the global economic crisis and the crisis of the Eurozone more specifically, Spain and Ireland were soon counted amongst the infamous "PI(I)GS" countries which have become the focus of speculative attacks in the financial markets (Portugal, Ireland, sometimes Italy, Greece and Spain have been called the "PI(I)GS").

Corporate Strategy and Industrial Development (CSID)
University of the Witwatersrand

Nicolas Pons-Vignon
E-mail: glc.csid@wits.ac.za

In fact, public debt rapidly increased in those countries as soon as the private spending and credit booms that had driven those economies before the crisis came to an end. (In Greece and Portugal both the government and (to a larger extent) the private sector had been in deficit even before the crisis.)

The important lesson to learn from the current crisis is that when the private sector financial balance is unsustainable, then the financial balance of the government will also be unsustainable, irrespective of whether it is in deficit or surplus. More specifically, the combined balance of the government and the private sector are a much better indicator of whether a country is prone to speculative attacks than merely the government deficit or the public debt. This partly explains, for instance, why Germany is considered as highly "creditworthy" by the financial markets, although public debt is much higher than in, say, Spain or Ireland and the 3% criterion of the SGP has been repeatedly violated since the introduction of the Euro. As a consequence, the focus of a new and better stability pact should be on current account imbalances.

How can we explain the large current account imbalances in the Eurozone? One important factor is the increasing divergence in unit labour costs. In a monetary union, changes in international price competitiveness can no longer be corrected through changes in nominal exchange rates. Rather, when changes in unit labour costs (which are closely related to national inflation rates) differ among member countries, then some countries persistently gain competitiveness relative to others. Now, between 1999 and 2007, unit labour costs have increased by less than 2% in Germany but by 28% to 31% in Greece, Ireland, Portugal and Spain. This means not only that all other countries have lost in terms of price competitiveness vis-à-vis Germany, but also that as a result of lower price inflation real interest rates have been higher in Germany. This contributed to the weakness of domestic demand, which was corroborated by an exceptional increase in income inequality and poverty (which depressed private consumption) and the retrenchment of the welfare state and public spending more generally (which increased precautionary personal saving and depressed the growth contribution of government expenditure). A lot of policy mistakes have certainly been made in the deficit countries as well. But a monetary union cannot survive in the longer term when its largest member country (Germany accounts for more than a quarter of the GDP of the Eurozone) hardly contributes to aggregate demand but follows an essentially neo-mercantilist growth strategy.

A new stability pact would therefore have to oblige countries with large current account deficits to take measures that reduce nominal unit labour costs growth and, in the final instance, to conduct a more restrictive fiscal policy. At the same time, when a country has an excessive current account surplus, fiscal policy needs to be more expansionary and wage moderation needs to be stopped. This is also true for the current situation, where the old SGP imposes fiscal consolidation plans on all countries simultaneously. While this implies a serious threat to growth for the Eurozone as a whole, a more sensible approach would be for the surplus countries to allow for an expansionary fiscal stance, as long as private demand remains fragile and current account imbalances remain large.

Till van Treeck is an economist at the Macroeconomic Policy Institute (IMK) in the Hans Boeckler Foundation in Duesseldorf, Germany.