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A Golden Rule for the Euro Area?[1]

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Abstract

Starting from a brief assessment of current macroeconomic conditions in the Euro area, we review the main, well-known arguments in favor of fiscal policy co-ordination and rule-based fiscal discipline in a monetary union. The rationale for imposing rules on national fiscal policies is most convincing when it comes to sustainability of public debt, whereas the current Stability and Growth Pact is framed in terms of deficits. Because it suffers from a number of fatal weaknesses, recently made apparent by the failure of major Euro area member-states to abide by its rules, the Pact is not credible and should be reformed. But how?

We propose that fiscal discipline in the Euro area be based on a variant of the British "golden rule" of public finance. We argue that, provided it is well designed and effectively implemented, such a rule would prove much superior to the current Stability Pact on almost all accounts, and that it would ensure a sustainable course for public finances in the Euro area.

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Introduction

Even before the launching of the European monetary union, in January 1999, there had been lively debates amongst economists about the degree of centralization of economic policy-making, and the amount of coordination amongst national authorities, in particular fiscal authorities, that would be required for a proper functioning of an integrated monetary area. Since the inception of the Euro area, the issue has continued to be discussed and a number of European policy-makers have expressed their views about the desirability of cooperation, coordination, harmonization, competition, etc. There have not been very tough oppositions to the weak coordination option chosen in the Maastricht and Amsterdam treaties though, essentially because the Euro area had lived, since its creation, through relatively tranquil economic conditions. Now, with the world economy undergoing a marked slump, and the European economy suffering at least a serious slowdown, and possibly facing more serious trouble ahead, the issues surrounding macroeconomic regulation in the Euro area, including in particular fiscal discipline and co-ordination, as well as the adequacy of the so-called policy mix (monetary and fiscal policies) are again featuring high on the political agenda.

With economic growth lingering around or even below 1 percent for the second year in a row and rather bleak prospects on that front[3], national fiscal policies have, in many member-states, entered an area of turmoil, feeding a lively, and open, debate on the rules for ensuring fiscal discipline in the Euro area. According to the Autumn 2002 forecasts of the EU Commission, two countries (Portugal and Germany) are certain to have "excessive budget deficits" this year, i.e. in excess of the 3%-of-GDP limit, and probably next year again, while France is entering the dangerous territory, when a deficit around 2.7% of GDP this year and foreseen at about 2.9% of GDP next year, and Italy, with 2.4% of GDP in 2002 and a foreseen balance of 2.2% of GDP in 2003, that the Commission judges little credible. The overall deterioration of budget balances in the Euro area is such that, after several years of continuous decline, the average public indebtedness ratio is foreseen to rise slightly for the first time in 2002, from 69.3% to 69.6% of GDP. On the inflation front, the situation is only slightly better, with an average annual rate of increase of consumer prices (HICP) falling from 2.5% in 2001, to 2.3% in 2002

[3] According to the Autumn forecasts issued by the EU Commission on November 13, 2002, average growth rate for the Euro area was only 1.5% in 2001, and would be a meager 0.8% in 2002 and slightly better, at 1.8%, in 2003. Note that in the forecasts published by the same institution a year before, the figures for 2001 2002 and 2003 were respectively 1.7%, 1.4%, 2.9%. The reasoning behind the recovery scenario being unchanged, but simply shifted forward by one year, it might be the case that what lies ahead is one more year of quasi-stagnation, instead of the predicted acceleration and recovery.

and a forecast 2.0% in 2003; but the dispersion of national inflation rates is quite large, with countries like Germany (1.4% in 2002) and France (1.9%) below the 3% self-imposed limit of the European Central Bank (ECB), but others, like Ireland (4.8%), the Netherlands (3.9%), Greece (3.8%), Spain (3.6%) and Portugal (3.5%) well above that medium-term target. In this context, monetary policy has remained unchanged over the past year, with the standard REPO rate stable at 3.25% since November 2001.

It has therefore become quite apparent that the rules governing national fiscal policies are not working satisfactorily, a fact acknowledged by a number of national governments and, recently, by the President of the Commission himself: the Stability and Growth Pact does not foster the pursuit of policies favorable to recovery and long-term growth, and it even induces perverse, pro-cyclical fiscal policies, so that it is not being obeyed, a rather uncomfortable position for a rule aiming at credibility. What then should be the reaction of European governments and the Commission? The latter seems willing to soften its interpretation of the rule, while preserving it: the Commission now talks in terms of structural budget deficits; they are therefore prepared to admit a cyclical deterioration, provided the aim of progressively reducing the cyclically adjusted deficit is maintained; the former are divided, with those governments having already consolidated their public finances protesting, while those in difficulty seem more willing to renegotiate the fiscal rules.

In this paper, we propose a new rule for fiscal policies in the Euro area. It is inspired by the British “golden rule”, or even by the French practice in local public finances, but amended to take the cyclical component into account. Section 1 discusses the difficulties surrounding macroeconomic policy-making and stabilization policies in a monetary union, summarizing the major conclusions of the literature. In Section 2, we restate the rationale for fiscal policy rules in a monetary union. Section 3 puts forward our proposal for improving over current arrangements. Finally, Section 4 offers some tentative concluding remarks.

1. ***Fiscal discipline and fiscal policy co-ordination in a monetary union***

Even though some kind of rules may be regarded as necessary in order to insure fiscal discipline in the context of a monetary union, the existence of such rules does not, in itself, suffices to

foster adequate co-ordination in cases it may be required: a rule is essentially a device for “negative” co-ordination (Boyer, ed., 1999). The issue of fiscal policy co-ordination has been specifically addressed within the framework of theory of optimum currency areas (OCA), originally proposed by Mundell (1961) and particularly well suited to the analysis of macroeconomic policy-making in the Eurozone.

1.1. Optimum currency areas and the nature of macroeconomic shocks

The first useful output of the OCA theory is the distinction introduced between to broad categories of temporary, macroeconomic shocks: those that hit and equally affect all countries in the monetary union, called symmetric, or common shocks; those that hit only a subset of countries in the union, called asymmetric, specific, or idiosyncratic shocks (see, for instance, Fatas, 1998; Obstfeld and Peri, 1998; Zumer, 1998; Boyer, eds., 1999; Echinard, ed., 1999). The former do not raise specific difficulties, at least insofar as the existence of monetary union, i.e. the impossibility of modifying relative prices by manipulating (nominal) exchange rates within the union, does not make a difference when it comes to stabilization policies (but see below).

The latter, however, make stabilization more difficult if the "spontaneous" adjustment mechanisms do not work properly, and hence active macroeconomic policies are called for to facilitate the adjustment. This is the situation in which some form of autonomy of national fiscal policies would ideally be required, along with some sophisticated form of co-ordination, and therefore the situation in which the current institutional arrangements in the Eurozone appear lest satisfactory (see, in particular, Eichengreen and Wyplosz, 1998; Debrun and Wyplosz, 1999; Fitoussi, ed., 2000).

1.2. Shocks and channels of adjustment in a monetary union

The most likely, and indeed most desired, outcome of market and monetary integration in Europe is a strengthening of economic ties and exchanges of all kinds. The Single European Act of 1986 was already predicated upon the view that deeper economic integration would bring more growth and prosperity. The move to monetary union was also largely justified by the idea that market integration would be incomplete if it were not accompanied and reinforced by monetary union (see, in particular, European Commission, 1990). And actually, a lot of

progress in terms of mobility of goods and services, financial assets and firms, and even, to some extent, labor, has been made since the completion of the Single Market, in January 1993. But it is also likely that, by removing a number of remaining obstacles to exchanges, those often referred to as transactions costs, monetary unification will take European economic and financial integration one step further. It is therefore likely to enhance competition and bring forth structural change.

One dimension of this structural change is spatial, and it is especially relevant for our discussion of convergence and economic governance: with increased mobility of goods and production factors, the economic geography of the European Union, and especially of the Eurozone, will change, and the spatial distribution of productive activities will evolve. But how exactly? The recent literature on economic geography (Krugman, 1992; Krugman and Venables, 1998) gives clues, but no unequivocal answer. Will more integration lead to more agglomeration of production facilities in those regions that already concentrate the largest share of industry and population, or will it lead to spreading at least some activities more evenly in the Eurozone? Will it lead to geographic specialization, according some form of comparative advantage, especially with enlargement to the East and the joining of new members whose production costs and natural endowments are significantly different from those of existing members?

This structural change and the likely spatial redistribution of production over the Eurozone has at least three types of implications: first, in a short-run, stabilization perspective, it should generate a new pattern of macroeconomic shocks; second, due to the enhanced responsiveness of location decisions of firms and individuals to economic incentives, it is likely to trigger a fiercer tax and social policy competition amongst European member-state governments attempting to attract businesses and high-income workers on the national territory; and third, these changes will have long-term consequences on the economic geography of the Eurozone and on interregional inequalities, that may be regarded as politically undesirable and may call for structural and redistribution policies of a broader scope than presently.

The completion of the Single market and monetary union is therefore likely to have consequences on both the nature and frequency of macroeconomic shocks --and in particular on whether symmetric or asymmetric shocks dominate in the future--, and on the relative

performance and merits of the channels of "spontaneous" (or market) adjustment to these various shocks.

1.3. Asymmetric shocks and the need for national fiscal policies

In recent years, a number of empirical studies have tried assess the magnitude of asymmetric shocks in the Eurozone, and the effectiveness of the existing channels of adjustment. Indeed, one of the major lessons from the OCA theory is that in the face of suck temporary shocks, adjustment may arise through various channels: the labor markets and labor mobility (Blanchard and Katz, 1992; Bayoumi and Eichengreen, 1993; Fatas, 1998; Obstfeld and Peri, 1998); financial and credit markets (Fatas 1998; Melitz and Zumer, 1999; Zumer, 2002); or the automatic stabilizers arising from the functioning of a sufficiently large, and sufficiently reactive central (federal) budget (Bayoumi and Eichengreen, 1993; Zumer, 1998; Echinard, ed., 1999). Do these channels appear sufficiently effective in the Eurozone, so that autonomy of active national fiscal policies would simply not be necessary?

In fact, as is well known, the labor market channels do not currently perform this way. And indeed this evidence explains the insistence of both the European Commission and the European Central Bank (ECB) in advocating structural reforms that would improve labor market flexibility, and reforms that would boost labor mobility: both are supposed to favor spontaneous adjustment to asymmetric shocks, thus making active fiscal policies less necessary at the national level (but, see, Fitoussi, ed., 2000). A similar negative conclusion is reached with respect to the central budget potential role in the regional stabilization task: in the EU, the central budget is both very small and much too rigid (i.e., not sensitive enough to current business conditions in the various countries) for it to play a significant role in this respect (Fatas, 1998; Zumer, 1998).

In the field of credit and financial markets, the current European situation and outlook are apparently less gloomy for stabilization. A number of recent papers (Melitz and Zumer, 1999; Zumer, 2002) actually show that this adjustment channel may be very effective in both inter-regional and international stabilization problems. But they also show that the fraction of the stabilization task that is effectively achieved through this channel in the Euro area is still fairly small, so that the use of active national fiscal policies, or at least of the automatic stabilizers in national budgets would in any case be required.

1.4. Monetary policy in an heterogeneous currency union

Although the ECB has a federal structure, with decentralized implementation of decisions, monetary policy in Euro area effectively is uniform and has to be decided and implemented for an economic area that proves to be much more heterogeneous than other existing currency areas and than what the so-called convergence phase preceding monetary unification has led many observers to expect. Of course existing currency areas do display regional differences, but probably not to the same extent as Euro area. The ultimate objective of the ECB — price stability — is clear and its instruments are by now well defined. But the relationships between the two are far from certain, at least in the initial stage of monetary union, and this makes monetary policymaking more difficult, more uncertain and less easy for financial markets and private agents to interpret and anticipate.

That current business conditions are heterogeneous amongst national economies in Euro area is by now amply demonstrated. Although not entirely unexpected, this state of affairs comes after a period in which macroeconomic convergence — albeit imperfect and on relatively unsatisfactory averages of low growth and high unemployment — has seemed to prevail. In retrospect, it appears that such a convergence was partly artificial, and was obtained with markedly different monetary policies being pursued in the various countries in the years preceding monetary union. But the current situation also reveals potentially important national differences in the transmission mechanisms of monetary policy instruments.

One such difference is related to existing heterogeneity in national banking and financial systems. Many recent studies have documented these discrepancies, as well as the resulting differences in the effects of a given monetary policy stance on the various national economies: a given interest rate variation does not appear to have the same impacts on national price levels and outputs. Such differences may eventually weaken as the process of financial integration proceeds and national banking and financial systems become more and more interdependent; but this process is only starting and may well take time. For at least a few years, national differences in the way the macroeconomy responds to common monetary policy will persist.

Another channel through which the common monetary policy differently affects the national economies in Euro area is the external exchange rate. Here again, it appears that the degrees of

openness to international —i.e. outside Euro area— trade differs markedly from one country to the other, and that the sensitivity and national macroeconomic performance to variation in the euro exchange rate is not the same everywhere.

Such national differences in the transmission mechanisms make the task of monetary policy making by the ECB particularly difficult and to some extent uncertain (see Masson, Krueger and Turtelboom, eds., 1998; Fitoussi, ed., 2000; Fitoussi and Le Cacheux, eds., 2002). As a consequence, they also make the reactions of financial markets to a given monetary policy stance less predictable.

In the specific context of fiscal policies, national differences in inflation rates, such as those currently observed in the Euro area, have disturbing consequences and implications. For one thing, they alter the sustainability conditions of public debt; and, on the other hand, they may call for different orientations of fiscal policies in the various countries, insofar as monetary policy is the same everywhere, but has differential impacts on domestic monetary conditions (see below).

1.5. Coordination in the face of symmetric shocks

In principle, symmetric shocks are not likely to raise difficulties in a monetary union according to the OCA theory: this is so because no infra-area relative price adjustment is required; hence the common monetary policy is apt to deal with this type of shocks. Nevertheless, it is often the case, in the context of a national economy, that the cost of adjustment to a shock is much reduced when both monetary and fiscal policies are used simultaneously, i.e. when the appropriate "policy mix" is implemented. In the context of currency unions, this would call for a double kind of co-ordination: a horizontal co-ordination amongst national fiscal authorities to collectively determine the overall fiscal stance of the union; and a co-ordination between the group of fiscal authorities and the central bank, to determine the adequate policy mix.

As is well known, the former co-ordination is plagued with problems arising from the collective-action nature of such a setting: the temptation to free-ride is likely to be present, and probably strong for national authorities of small countries.

Regarding the co-ordination between the "club" of national fiscal authorities --the Eurogroup, in the context of the Eurozone-- and the ECB, the risk is that, in the absence of credible commitments or other forms of mutual trust, the two parties may engage in a "game of chicken" (Fitoussi, ed., 2000), in which each party threatens the other player with a tit-for-tat strategy and actually implements it. The current macroeconomic policy deadlock, in which the ECB refuses to lower its interest rates, while a number of national governments insist that they cannot abide by the Stability Pact, may be seen as a perverse variant of this game, in which the ECB looks at the average inflation in the Euro area, whereas national governments are facing different domestic inflation rates.

2. Rationales for fiscal policy rules in a multilevel government setting

The questions of whether macroeconomic policy instruments should be left in the hands of governments, especially in democracies, and, if yes, whether their use of such instruments should be constrained by "constitutional" rules have long been central concerns of economists, and have in particular inspired the literature on public choice (Buchanan and Tullock, 1962; Mueller, 1999). In the specific field of traditional macroeconomic stabilization policies -- i.e. monetary and fiscal policies --, these issues have been dealt with according to various analytical perspectives, providing a variety of, more or less convincing and empirically relevant, rationales for imposing rules on monetary and fiscal policies. With regard to the former, which will not be discussed in this paper, it has led, in most developed countries over the recent past, to the adoption of a statute of independence of central banks, which has also, in a rather extreme version, been the case for the European monetary union. Concerning fiscal policies, that, in the present institutional arrangements in the EU, remain in the hands of national governments, the question is whether markets and competition may suffice to ensure fiscal discipline and monetary stability, or whether a rule --or a set of rules -- constraining national fiscal authorities is necessary. Over the past decades, economic literature has offered a number of rationales for fiscal policy rules in a decentralized government setting.

2.1. Market discipline versus rules

Before turning to the specifics of fiscal policy rules in multilevel government settings, it is useful to recall the terms of the long-standing debate amongst economists over the general issue of whether fiscal policies ought to be constrained by "constitutional" rules, or whether the market will exercise sufficient discipline to avoid "excessive" public deficits and unsustainable public debt accumulation, which would eventually force the central bank to monetize the debt and hence lead to inflation, as simple monetarist theory suggests (Sargent and Wallace, 1981) and many historical episodes have illustrated (see, in particular, Flandreau, Le Cacheux, and Zumer, 1998). The simple idea behind the imposition of rules is that financial markets are not efficient enough, and suffer from too many informational deficiencies, so that they will not be able to sufficiently raise risk premia on the debt of those governments that conduct unsustainable fiscal policies, or rather that the increase in the risk premium will be too small

and too late to avoid fiscal crises resulting from the over-accumulation of debt (see, in particular, Bayoumi and Masson, 1992; Buiter, Corsetti and Roubini, 1993).

2.2. Rules versus discretion and the issue of credibility

Another strand of modern economic literature on rules *versus* discretion in macroeconomic policy-making has emphasize issues of credibility in contexts where private agents have rational expectations with respect to price formation mechanisms in the economy. In the original contribution by Barro and Gordon (1983), private agents have perfect foresight of future inflation and the credibility problem arises from the incentives for public authorities that control monetary policy --and, in their analysis, hence perfectly control the price level-- to renege on their promises to deliver monetary stability (low inflation): if not constrained by rules, monetary authorities have an incentive to make "surprise" inflation, and because private agents expect this to happen, actual average inflation is higher than the optimal rate. If instead monetary authorities can credibly pre-commit themselves to monetary stability, or if credible rules[4] may somehow be imposed upon them, then actual inflation will be lower, with no loss in terms of employment and GDP. Thus, in this line of reasoning, due to problems of time inconsistency that plague the decision-making process of public authorities, rules appear to dominate discretion by making policies more credible. When applied to the case of monetary policy, this reasoning leads to the conclusion that central banks should be independent from political authorities and that monetary policy should obey a fixed, pre-announced rule, a well-known monetarist tenet which has been shown in more recent contributions not to be fully supported by theory, and never followed in practice (Taylor, 1993; Clarida, Gali and Gertler, 2000). In the context of fiscal policies, this reasoning is, of course, a major rationale for a fixed rule, such as the Stability Pact ceiling on budget deficits; but the same objections raised against fixed monetary rules apply to fiscal policy as well (Buiter, Corsetti and Roubini, 1993; Eichengreen and Wyplosz, 1998).

2.3. Spillover effects and the need for rules in a decentralized system

Whereas none of the previous arguments is in any way specific to the context of federations or, more generally, multi-level government settings, some justifications of fiscal policy rules rest on

[4] The issue of which rules should be regarded as credible is another matter, that will be discussed later in this paper.

the notion of spillover effects amongst decentralized governments in an economically and financially integrated area. Indeed, the spillover arguments appear to have inspired the specific rule chosen in the Maastricht Treaty and carried forward into the Stability Pact. This line of reasoning is based on the existence of interdependencies amongst decentralized governments, due to market integration: "excessive" public deficits in one country will thus inflict nuisances, such as higher interest rates, threats of higher future inflation, etc., on partners, in a way similar to pollution or any other external effect (Bayoumi and Masson, 1992; Buiter, Corsetti and Roubini, 1993). The precise sources and nature of these spillover effects are not always clear; but there does seems to be empirical evidence in favor of this rationale, most notably the co-movements in long-term interest on public debts in federations and, since the inception of monetary union in Europe, the observed similar co-movements and the very narrow band of risk premia on European governments' debts.

2.4. Monetary regimes and fiscal policy rules

Until recently, the issues of rules for monetary and fiscal policies had been analyzed separately, although Sargent and Wallace (1981) had long warned that there would likely be inconsistencies between fiscal and monetary policies in this case, usually resolving itself eventually into higher inflation in the long run. In recent years, a unified theoretical framework has been proposed to deal with the interactions of fiscal and monetary policy regimes, and assess their consequences in terms of inflation, or rather the determination of the price level. Although this Fiscal Theory of the Price Level (FTPL) (Leeper, 1991; Woodford, 1996) is not entirely convincing, and does not seem to be well supported by empirical evidence, at least in major OECD countries (Canzoneri, Cumby and Diba, 2001; Creel and Le Bihan, 2002), it provides a useful analytical framework to think of the issue of rules in the Eurozone. Indeed, the FTPL shows that there may be various combinations of monetary and fiscal policy regimes, some of which yield unstable developments in the price level, while others make the price level determine and macroeconomic equilibrium stable. In particular, the FTPL shows that if monetary authorities are independent and pursue an active monetary policy of price level stabilization, fiscal authorities have to be "Ricardian" (Woodford, 1996) in order for the price level to be stable: a solvency and sustainability rule has to be imposed on fiscal policy. But the symmetric case, in which monetary policy is passive and fiscal authorities are free to implement the fiscal deficits they choose to is equally possible and also yields a stable equilibrium in which the price level is

perfectly determined: in this case, a rule would have to be imposed on monetary policy, while fiscal policy would be discretionary and fiscal authorities would choose the price level.

3. Which rules?

Agreeing on the necessity of rules to constrain national fiscal policies in a multilevel government setting leaves open the question of the precise nature and content of the rules. As is well known, the Eurozone has the Stability and Growth Pact, which essentially imposes a 3%-of-GDP ceiling on national public deficits. This Pact has been supplemented by Broad Economic Policy Guidelines (BEPG) which, in the field of fiscal policies, include the so-called national stability programs describing medium-term public finance strategies of national governments. While the strict respect of the Stability Pact is currently threatened by adverse macroeconomic developments in some EU countries, the national stability programs have, for the most, never been implemented strictly and are currently subject to large revisions. These difficulties raise questions on the credibility of the current institutional setting and re-open the debates on the precise nature of the fiscal policy rules in the Euro area (Creel, Latreille and Le Cacheux, 2002).

3.1. Public finance rules for monetary stability

Whereas it is dubious that rules could solve the fiscal policy co-ordination problem in the Euro area, there is little doubt that rules are needed to prevent governments from engaging in policies that would be detrimental for the union as a whole, by undermining the commitment to price stability. But then, the rule should entail sustainability of public finance developments rather than anything having to do with current flows, such as the current budget deficit. The rule should then target the public debt ratios, setting a medium-term objective for it, similar to what had been done in the Maastricht Treaty[5].

As is well known, the sustainability condition for public debt dwells on the difference between the apparent nominal interest rate on public debt and the nominal growth rate of the domestic economy. Implicit in the current European fiscal rules is the, unwarranted, assumptions that inflation rates are the same all over, and that public expenditures –or, for that matter taxes-- have no effects on the nominal growth rate. Because the various member states are currently

[5] Whether it is aimed at a 60%-of-GDP figure or any other is really a matter to be discussed, with no particular meaning attached to the figure. Clearly, however, a zero target would not make much sense, unless one has other reasons for aiming at the disappearance of public debt in Europe. Everybody knows that the debt criterion was not included in the Stability Pact because a number of countries entered monetary union with debt ratios well above the 60%-of-GDP ceiling.

facing different inflation rates, while nominal interest rates are very similar across the Euro area, domestic real interest rates are widely different, so that domestic monetary conditions are effectively different. This may be seen to yield various implications: if one takes this and the current fiscal rules for granted, it would imply tighter fiscal policies in countries having lower than average inflation rates, a counterintuitive predicament; at the opposite end of the spectrum, one may be inclined to conclude that either monetary policy should be loosened, but then average inflation would have to increase and the problem would not be solved, or the fiscal rule should somehow take real interest rate differences into account, for instance by looking at the primary deficit[6].

But the other side of the condition matters a lot too. Indeed, the current fiscal rules seems to be based upon the assumption that fiscal policies do not influence potential growth[7]. Of course, lip service is being paid to the consequences of improved public spending and better conceived taxation on long term growth. But in practice, the Stability Pact has mostly led to cuts in income taxes in good times –with debatable effects on long-term growth-- and above all to cuts in public investment expenditures in bad times, a move that is clearly detrimental to potential growth.

3.2. Serious drawbacks of the current rules and a reform proposal

Even before the inception of monetary union, many economists had criticized the precise content of the fiscal policy criteria that had been included in the Maastricht treaty, and especially the public deficit ceiling that went unchanged into the Stability Pact (Buiter et al., 1993; Creel and Sterdyniak, 1997; Obstfeld and Peri, 1998; Eichengreen and Wyplosz, 1998). The major problems with the current rule, in addition to its dubious credibility, are, first, its

[6] A number of authors have long recommended this kind of rule (e.g., Creel and Sterdyniak, 1997). In a recent paper (Creel, Latreille and Le Cacheux, 2002), we take a more negative stance on this, because it would, if implemented in the simplest way, award more margins of maneuver to those countries with already high debt ratios, which would be contrary to the goal of long term sustainability.

[7] The blame inflicted in 2001 upon the Irish government overly expansionary fiscal policy, at a time when the letter of the Stability Pact was being respected, but Irish inflation was much above average, may be interpreted as the recognition that in a monetary union, national fiscal policies may be used as a tool to fight domestic inflation…

pro-cyclical bias, and second its induced consequences on public investment expenditures, hence on future potential growth of the economy[8].

The 3%-of-GDP figure is, of course, a perfectly arbitrary choice, dictated by the circumstances at the time when the Maastricht Treaty was written and actually aimed at forcing a number of European governments that had large public debt ratios at the time to consolidate their public finances. Thanks to the relatively favorable macroeconomic environment of the first two years of existence of the Eurozone and to the previous efforts made by many governments to reduce public deficits and debts before entering monetary union, the deficit ceiling in the Stability Pact did not prove excessively binding until recently. But, because it now appears that even some large countries of the EU have difficulties to strictly abide by the rule, its credibility itself is shaken, and with it, the credibility of the whole Stability Pact (Fitoussi and Le Cacheux, eds., 2002; Creel, Latreille and Le Cacheux, 2002).

Moreover, many economists have long argued that fiscal policy rule based imposing a ceiling on the ratio of current public deficit to GDP would have a number of drawbacks, especially the pro-cyclical bias it forces on fiscal policies. This pro-cyclical bias, which aggravates business fluctuations, has been quite apparent even before the launching of monetary union, during the decade of weak growth performance that has preceded (Fitoussi, ed., 1999). It has also been observed since then: over the first two years of existence of the Euro area, the overall favorable business conditions have led national governments to relax their efforts to reduce deficits and instead induced them to increase expenditures and cut taxes at a time of buoyant economic activity; and, symmetrically, national governments now have to implement more restrictive fiscal policies at a time of slow growth, or even recession in some countries. This long-identified bias has even been recognized by the Ecofin Council itself. Remedying to this problem may involve changing the rule and moving to a ceiling in terms of cyclically adjusted public deficit, i.e. a structural budget deficit (see, for instance: Buiter, Corsetti and Roubini, 1993; Creel and Sterdyniak, 1995; Eichengreen and Wyplosz, 1998). Even the Commission seems to have taken this point on board and is now discussing prospects in terms of structural deficits.

[8] Although we will not deal with the issue here, it should be recalled that these problems are compounded with those arising from tax competition within the EU (see, for instance, the analyses and discussions in Kambur and Keen, 1993; Sinn, 1997 and 2001; Le Cacheux, 2000; Salmon, 2000).

In addition, the current European fiscal rule tends to produce an excessive contraction in public investment spending by national and sub-national governments, which may be detrimental to growth and may run counter other European Union objectives, such as, for instance, those announced in terms of transportation networks. This bias against public investment arises from the political difficulty entailed by cutting current expenditures, which are essentially made of civil servants' wages and transfers to households, or by increasing taxation in the face of a forthcoming slowdown in economic activity. To avoid such a bias, the public deficit ceiling would have to be formulated in terms of a "golden rule of public finance", similar to the one currently ruling the British budget, which has a medium-run target for the net-of-public-investment deficit. In the case of the Euro area, the combination of these two amendments would lead to adopting a fiscal rule that would have a ceiling --possibly zero, if one wants to signal fiscal "virtue"-- on the ratio to GDP of the structural, net-of-public-investment public deficit (Creel, Latreille and Le Cacheux, 2002).

*4. **Concluding remarks***

Of course, reaching an agreement on what is "structural" may not be easy; but it is not seen to be out of reach and the Commission is working on it. Agreeing on what is "productive public investment spending" may be even more difficult; but after all, this is the kind of conventions upon which private accounting is built, and a thorough discussion of public accounting practices would be welcome. To the extent that the expenditures included in the category of public investment are effectively productive, the proposed amended golden rule will ensure stability and sustainability, while being conducive to higher long-term average growth and short-term, differentiated stabilization policies. Thus, the overall objective of price stability, which implies long-term sustainability of public debts, would be preserved.

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