Luiss
School of European Political Economy

Reform of the Stability Pact:
First principles

Stefano Micossi

Policy Brief 5/2022

LUISS

January 27, 2022

Reform of the Stability Pact: First principles[1]

Stefano Micossi

A crowded seminar held by the Astrid Foundation has launched in Italy the discussion on the future of the European Stability and Growth Pact (SGP), and economists are churning out paper after paper on the subject.

I would start with two premises, one analytical and one methodological. The analytical one is that, while an increase in the public deficit in the short term certainly supports growth, this may not necessarily be true in the medium term, for example, if public spending increases inefficiencies in the allocation of resources. The increase in public debt (beyond certain not well-known thresholds) in turn produces adverse effects, generating expectations of higher future taxes and fears among investors about the solvency of the debtor. There is little discussion on these aspects in Italy. The public narrative is that more public spending is good for the economy (it is certainly good for political parties), therefore even looser European constraints on public debt are generally a good thing. Little attention is paid to the fact that Italy's growing public debt has now coexisted with diminishing growth and productivity for several decades, to the point of almost complete stagnation.

The methodological premise is that the Stability and Growth Pact was introduced before the launch of the euro as protection against possible misbehavior of a member country in the management of its public finances - or economic policy - with possible spillovers on the financial stability of partners and of the eurozone (of the Union) as a whole. The goal was to limit excessive behavior, leaving member countries free to independently pursue their own national economic policies. It is now a question of assessing whether that approach is still valid, or whether the revision of the pact should offer greater ambitions in terms of European coordination of national economic policies.

First of all, it is a question of deciding whether the Maastricht parameters - 3% of the deficit in relation to GDP and 60% of the debt - are still valid references, or should be modified. The modification of the reference values is feared by the 'frugal' countries of the North, which fear the lax signal that would be presented to the public and to the countries of the South. But, at least for the debt, maintaining the value of 60%, in an economic system in which the debt/GDP ratio is now 100%, would not help to maintain the credibility of the SGP, forcing the creation of adjustment paths for individual countries

[1] This paper was first published as an article in the Il Sole 24 Ore newspaper on January 21, 2022.

that would be very prolonged over time (it would be even more difficult to differentiate countries according to the quality of spending along the adjustment trajectory).

French Economy Minister Bruno Le Maire believes that working on the adjustment path may prove acceptable to German partners. Some Italian scholars (Amato, Bassanini, Messori and Tosato) have hypothesized about a much more incisive strengthening of the SGP, which would go so far as to bind member countries with a methodology similar to that applied to national NRRPs, which implies the setting of detailed quantitative and qualitative objectives (perhaps underestimating that the NRRP provides financial resources, while the SGP tends to take them away). Others see an opportunity to move forward in establishing a permanent European fiscal capacity (Bordignon, Cottarelli, Pisauro), also taking into account the enormous investments required by the green transition. German Finance Minister Christian Lindner dismissed these arguments by saying that the necessary investments will be made by private firms (in reality he is also planning to finance them with one-off off-budget public spending). Progress in these directions does not appear likely until we see how the national NRRPs are working, primarily the Italian one.

Finally, we will also have to decide what to do with the sovereign debt accumulated by the European system of national central banks. The problem arises because, under the treaties, it is likely that the ECB will not be able to hold those bonds when the monetary policy reasons that led to those purchases disappear.

Since 2019 I have been making proposals to have these securities purchased by the ESM, the bailout fund; in a recent paper I reformulate the proposal in a way compatible with European law, making the scheme practicable. Carlo Cottarelli has proposed to leave sovereign bonds with the ECB, reducing excess liquidity with a new compulsory reserve on banks, but does not comment on the legal feasibility of the proposal. Saraceno and Giavazzi, together with their other economist colleagues, also ventured out on this terrain, with separate contributions; their proposals have many interesting aspects, but do not seem consistent with the current state of the European treaties.

The issue is thorny, but the return of inflation, with the related need of the ECB to get rid of the sovereign bonds in its portfolio to reabsorb excess liquidity, will bring it closer to the Ecofin Council table.