

The Stability and Growth Pact: Lessons from the Great Recession.

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The Great Recession, the global financial and economic crisis that erupted in 2007, has revealed a number of weaknesses in the EU framework for fiscal surveillance and fiscal policy coordination as enshrined in the Stability and Growth Pact (SGP). First, existing provisions concerning the reporting of government finance statistics did not guarantee the necessary quality of data across all countries. Second, in the economic good years preceding the crisis the SGP did not encourage Member States to create fiscal space for bad economic times. Second, the fundamental tenets underpinning the Pact, namely that fiscal discipline coupled with low and stable inflation would be sufficient to secure overall macroeconomic stability, turned out to be wrong. Important macro imbalances outside the fiscal area translated, to a significant degree, into government liabilities when they unwound during the crisis. Third, the SGP lacked provisions to mitigate severe economic stress. It does not allow for discretionary fiscal expansions, unless a country has significantly overachieved its budgetary objectives. The stabilisation function of fiscal policy is entrusted to automatic stabilisers which in the face of the Great Recession were deemed not to provide sufficient support. Fourth, the EU fiscal surveillance also lacks a framework for crisis resolution, notably when it becomes a sovereign debt crisis as was the case in spring 2010.

In clear contrast to the first crisis of the Pact in November 2003, when Germany and France decided to flout the provisions of EU fiscal surveillance, many observers no longer believe the Pact can be mended. In the current debate, the focus is no longer on how to improve this or that part of surveillance as was the case in 2004-05. The prevailing view now seems to be the following: do not shed additional tears on a dead body; rather concentrate on what to do when the chips are down.

We do not share this gloomy view. In our paper we acknowledge the shortcomings of the Pact mark-II, yet believe it is worth preserving and can and should be revived. We provide a diagnosis of how the SGP fared ahead and during the present crisis and offer a first comprehensive review of the ongoing academic and policy debate, including an account of the reform proposals adopted by the Commission on 29 September 2010.

In our view, the current system of EU rules is unbalanced. It consists of very specific provisions on how to conduct fiscal policy making in normal times with no effective enforcement mechanisms, and of no or extremely tight provisions for really bad economic times, like the Great Recession. A two-pronged approach is needed to revive the Pact: tighter enforcement, coupled with broader macroeconomic surveillance, in good times and an open window for exceptionally bad times, including a crisis resolution mechanism at the EU level.

We present explicit recommendations and proposals on how to repair the SGP, in short how to make it work better. Our recommendations are close to the reform proposals advanced by the Commission on 29 September 2010 which in turn largely overlap with the conclusions of the Task Force of the European Council of 18 October 2010.

Deep economic crises initiate a learning process – a search for new policies to avoid future economic calamity. EU is now in the middle of such a learning process. In the past, EU has been able to adjust to new conditions and new circumstances. There are strong reasons to believe that proper policy adjustments will be forthcoming, initiated and supported by the workings of financial markets. We conclude that the EU has a golden opportunity to learn from the mistakes of the past.