

4th February

Confidential

To: Mr. Baer

From: Mr. Jenkinson

Copies: Mr. Borsch
Mr. Christiansen
Mr. Giles
Mr. Guiomard
Mr. Monticelli
Mr. Petit
Mr. Scheller
Mr. Strauss-Kahn
Mr. Stubbe
Mr. Viñals

Excessive Budget Deficits and Sanctions in EMU

I attach a short summary of the Monetary Committee Alternates meeting in Brussels on 1st March, together with two relevant background papers.

Nigel Jenkinson

EXCESSIVE BUDGET DEFICITS OF SANCTIONS IN EMU

(MONETARY COMMITTEE ALTERNATES MEETING - 1 MARCH 1991)

The Monetary Committee have made some progress on the issue of defining an "excessive budget deficit" in Stage 3 which would trigger further detailed examination and if necessary remedial action.¹ A reference document has been produced,² which recommends the use of two criteria:

1. Unsustainability criterion: a government has a debt-to-GDP ratio greater than a reference value, and has taken insufficient action to stabilise or reduce it.

2. Economic instability criterion: a government's deficit exceeds its investment expenditure over a number of years (the golden rule) and its deficit as a ratio to GDP exceeds a reference value.

Failure to satisfy either would be sufficient to initiate the excessive deficits procedure. The Alternates had been asked to put flesh on the bones by identifying possible reference values and resolving any outstanding technical and definitional questions. To assist this task the Commission had produced a study of fiscal deficits in the 1980s which showed how the criteria would have performed historically.³ The Alternates had also been asked to give preliminary responses on the issue of sanctions that might be applied in the event of an excessive deficit.

The new Chairman of the Alternates, Fugmann (Danish Economics Ministry), had a difficult baptism, as several Alternates wished to unravel elements of the agreement that had been reached in the plenary Committee, but by skilful chairmanship he managed to achieve some consensus in a number of areas. Nevertheless, progress was slow and the Alternates agreed to return to the outstanding questions on 22 March, following further discussion in the full Committee on 13 March.

One area of confusion, which clouded much of the discussion, concerned the procedure which would follow the identification of an

1 However, the United Kingdom continues to maintain a reserve in this area.

2 "Criteria for Excessive Deficits", 25.2.91 (copies enclosed).

3 "Criteria for Excessive Deficits: Applications to Real World Examples", 7.2.91 (copies enclosed).

excessive deficit in Stage 3. Some thought that in the first instance a full review of budgetary policy would be carried out by the Monetary Committee, and that depending on the result of the examination, the Monetary Committee would recommend whether or not the issue should be taken further. Others pointed out that this was incorrect, noting that according to present drafts, the Monetary Committee would undertake the preparation, but that the special procedure to identify and resolve excessive deficits would be conducted in the Council of Ministers. There was thus no mechanism to stop all cases of a the breaching of a threshold being reviewed by Ministers. Some Alternates queried the wisdom of this approach, and it was agreed that they would recommend to their representatives on the full Committee that the issue should be reconsidered (Fugmann viewed it as inappropriate that such a request should come from the Alternates collectively).

A further general difficulty concerned the status of any agreed numerical threshold. Some Alternates feared that they may become cast in stone, and may not be very relevant in 1997 or 2002 or whenever they may be applied. Fugmann observed that the numbers were needed to push the discussion forwards, but that they would certainly be reviewed before they became binding. He also noted, however, that the criteria may be used to help identify entry thresholds in the fiscal area for progression to Stage 3.

After examining the historical evidence, the Alternates agreed that both criteria in the reference document were necessary and that both parts of the economic instability criterion were required.⁴ There was much less consensus on the reference values to be set. Community averages won little favour, although there was recognition that any strict numerical value was equally arbitrary. After a long discussion, seven countries were willing to accept a threshold for the unsustainability criterion: "around a

4 Although the golden rule has been historically a stricter test than a reference deficit of 4% of GDP (the Community average in 1990), this may not hold in the future.

net debt to GDP ratio equivalent to a gross debt to GDP ratio of around 60%."⁵

The five countries dissenting (Belgium, Spain, Greece, Ireland and Italy) felt that the threshold was too low, and that as a result too many deficits would be regarded as "excessive".

There was little discussion of the reference value for the deficit/GDP ratio as part of the economic instability criterion, which will be on the table for the next meeting. It was agreed, however, following a French intervention, that the combination of the golden rule and the fiscal deficit ratio in one criterion was sufficient to eliminate the need to take averages over a number of years - the joint criterion would apply in each and every year.⁶

There was no time to discuss the role of complementary indicators in assessing the fiscal stance, relating for example to the macroeconomic environment or to the country's standing in financial markets (see paragraph fifteen of the Monetary Committee paper), or to resolve outstanding definitional questions (for example, relating to the definition of government). These too, will be covered at the next meeting.

Sanctions

The Alternates had a first discussion on the question of sanctions which may be taken in the event that the Council rules that a deficit is excessive, following a previous recommendation which has proved to be ineffective. The issue is closely linked to the IGC on Political Union as well as to that on EMU. The Chairman suggested that the subject could be discussed under the following three headings:

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- 5 The full Committee had agreed that the operational concept of debt should be calculated "net of certain liquid, or perhaps readily marketable debt" without providing any workable definition of what this involved in practice. In the absence of any data, the Commission analysis was based on gross debt. 60% is the current average gross debt to GDP ratio in the Community, although this is a "coincidence". More work will be undertaken by the Alternates on the basis of net debt, after a workable definition has been agreed.
- 6 Both the golden rule and the deficit to GDP ratio are affected by cyclical fluctuations. This would be allowed for in the threshold for the deficit to GDP ratio.

1. The market-oriented approach - Designed to accelerate normal market forces by, for example:

- (a) Requiring the ESCB to abstain from purchasing the offending government's paper.
- (b) By changing the offending government's status under the solvency ratio directive.
- (c) Through disclosure rules in government debt prospectus.

2. Approaches through the Community budget - for example, by suspending payments from the Community, or by levying fines.

3. The direct application of Community law - for example, by suspending the right to vote in the Council for a country running an excessive deficit, or by introducing a direct link to the national budgetary legislation.

Alternates supported this categorisation, noting that the three were complementary rather than substitutes. Most discussion centred on the "market-oriented" aspect, following some of the ideas that have been put forward by Graham Bishop. Whilst all were in favour of market mechanisms, the specific suggestions (1(a) and 1(b) above) came in for near universal criticism - the sole defence coming from France who have embodied the first suggestion in their draft Treaty proposal. Other members thought that 1(a) infringed the independence of the ESCB as well as causing difficulties for monetary policy operation, whilst 1(b) was viewed as dangerous, by interlinking excessive budget deficits with prudential considerations. Option 1(c) was criticised less, although the German representatives noted that government bond issues in Germany currently did not have a prospectus. They also queried the willingness of national governments to include a health warning in their own prospectus.

The British representatives suggested that a requirement to mark government paper to market could form another market-enhancing mechanism, which won some support from other Alternates. They also noted that in their view the no bail-out clause was important in stimulating discipline by the market. This is one reason why the U.K. did not favour the introduction of a new Community facility.

There was relatively little discussion on the possible use of the Community budget as a sanction, although some speakers suggested that a system of fines might be the easiest to implement, as it avoided legal questions of whether or not Community transfers were made to individuals and companies rather than to governments. It would also allow the punishment to be more closely tailored to the crime.

Fugmann closed the discussion of sanctions by asking members to write in with any further contributions, particularly on developing aspects of the market-oriented approach.

Capital liberalisation

The first hour of the meeting was taken up with the annual review of restrictions on capital movements, which indicated that there were a substantial number of indirect controls in place, for example, in the field of tax discrimination and restrictions on the investments of institutional investors.⁷ The Commission views some of these as incompatible with Community law. The most interesting point of substance was a debate on the issue of tax harmonisation which some felt was necessary to avoid distortions to capital movements (Italy, France, Spain). Others (U.K., Netherlands, Luxembourg, Denmark, Commission) stressed that tax discrimination (the relevant issue for a survey of restrictions on capital movements) was completely distinct from tax harmonisation.

7 I have copies of all the relevant papers.