

On Straightjackets versus Coordination*

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Calls for comprehensive policy packages to lift the world economy out of its doldrums have become a mantra for policymakers and international institutions. The IMF's note on Global Prospects and Policy Challenges for the July 23-24 G-20 Meeting in Chengdu is among the latest examples, echoed by the Communique issued by the G-20 finance ministers and central bankers at the end of the meeting. Along with other policy actions, the IMF recommends that countries should use "available fiscal space" to implement macroeconomic support.¹ On the same day, Mario Draghi once again invited euro area countries to use active fiscal policies, "while remaining in compliance with the fiscal rules of the European Union."²

But the fiscal rules of the EU and the lack of effective fiscal coordination between its member countries make it exceedingly difficult to accomplish what Europe needs. Among other requirements, the Stability and Growth Pact (SGP)—eventually reformed into the Fiscal Compact—imposes an exogenous constraint on the size of government deficits at a maximum of 3% of GDP. This creates a stumbling block for effective use of countercyclical fiscal policy in response to large shocks, or to smooth transition costs associated with structural market reforms.

It is time to consider ditching the SGP straightjacket. Contrary to what EU documents, institutions, and several policymakers and scholars would have us believe, the SGP is *not* an effective instrument of actual fiscal policy coordination—if by coordination we mean the accomplishment of mutually beneficial cooperative outcomes.

The SGP is a legacy of efforts to keep Southern Europe out of the euro that go back to Wolfgang Schäuble and Karl Lamers' idea of a "variable geometry" approach to European integration.³ Once the efforts to prevent accession by Southern European countries failed, the focus should have been on designing and ensuring effective fiscal coordination in the euro area subject to the only constraints that should matter—the governments' intertemporal budget constraints. Instead,

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¹ See <http://www.imf.org/external/np/g20/072116.htm?hooftPostID=cafafe107d1d6f6deb396b760b2f5dd6>.

² See <http://www.ecb.europa.eu/press/pressconf/2016/html/is160721.en.html>.

³ I discussed the recent resurgence of this idea in a VOX-EU column available at <http://voxeu.org/article/variable-geometry-bites-back-sch-uble-s-motives>. The SGP requirements have roots in the convergence criteria of the Maastricht Treaty, which were intended to keep undisciplined Southerners out of the euro. An excellent exposition of this argument is in Barry Eichengreen's book on "Globalizing Capital: A History of the International Monetary System" (Princeton University Press, 2nd edition, 2008).

the EU has been clinging to an arbitrary straightjacket that is far from ensuring the outcomes that would be generated by optimal coordination, and that, in fact, has clearly proved far from optimal.⁴

Even if we were willing to believe that optimal coordination without the SGP would not imply Southern European deficits above the SGP limit, optimal cooperative policy in the current circumstances would almost certainly imply more expansion in Germany than in the South. The lack of macroeconomic imbalance adjustment in Europe is reminiscent of the failure of international adjustment in the interwar Gold Standard, when surplus France would force all the burden of adjustment on deficit Britain, and lack of cooperation resulted in a contractionary bias of (monetary) policy that contributed to the depth and propagation of the Great Depression.⁵

Clinging to suboptimal rules, combined with Germany's resistance to performing its share of the adjustment, is hurting everyone—including Germany, which could actually use a significant infrastructure upgrade. The EU would be much better served by focusing on achieving actual cooperative outcomes rather than passively adhering to rules that have been contributing to the erosion of political support for the European project in many countries. If a fiscal union is eventually established, it should not feel the need to impose more constraints on its decision-making than the plain old commitment to intertemporal sustainability of its finances.⁶

⁴ And de facto unenforceable when the large countries—France and Germany—violated it. It is also worth noting that Germany broke the SGP deficit constraint when it began implementing the Hartz Reforms of its labor market in 2003.

⁵ See Eichengreen's 1984 *Explorations in Economic History* article on "Central Bank Cooperation under the Interwar Gold Standard."

⁶ For readers who are more technically inclined, notice that I am not advocating fiscal policy under discretion. The outcome that should be pursued is Ramsey-optimal cooperative policymaking, which assumes commitment—but not commitment to essentially arbitrary rules.