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Downturn putting EU discipline to the test

Spending to shake malaise away could run into deficit rules

By Matthew Saltmarsh

PARIS: With an economic downturn looming, some of Europe's leading countries are facing a difficult choice: spending themselves out of the doldrums or adhering to the fiscal discipline intended to maintain the integrity of the euro.

For countries like France and Italy, the crisis is one they struggled through half a decade ago — and by and large escaped when the European Union's deficit rules were loosened and the overall economy improved, helping bring their budgets back in line.

Now some of the same countries — with the notable exception of Germany — are facing similar challenges heading into 2009. But there are doubts about whether the revised EU rulebook has enough teeth left to prevent an erosion of confidence in the euro, the Continent's primary currency.

Informal discussions are likely among top EU finance officials when they gather in Nice on Friday and Saturday, having just received new economic growth forecasts from the European Commission, scheduled for release Wednesday.

In Frankfurt on Tuesday, the commissioner for economic policy, Joaquín Almunia, was pessimistic about the outlook. "Over all, the situation is unusually uncertain," he said during a speech.

In an early warning shot, he called for governments to avoid "distortionary tax policies" and "maintain this commitment to fiscal discipline," especially those with fast-rising deficits.

So far, there has been limited budgetary loosening in Europe and there is no expectation of anything like the estimated $170 billion in tax breaks enacted in Washington this year.

But the longer the downturn in Europe lasts, the more chance there is that governments will try to expand their budgets, analysts said, especially as the independent European Central Bank appears reluctant, faced with high inflation, to stimulate activity by lowering interest rates.

"The biggest test to the pact since the changes of 2005 is coming up as we enter a cyclical downturn," said Sebastian Barnes, a senior economist at the Organization for Economic Cooperation and Development in Paris. "The test will be partly political and partly economic."

Positions will become clearer after the national budgets are presented this autumn. Any serious slippage could set the scene for another round of wrangling in Brussels between ministers and the European Commission, which polices the system.

"It's likely that we'll see some drama again," said Daniel Gros, director of

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Downturn is putting EU fiscal discipline to the test

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the Center for European Policy Studies in Brussels. "The key question now is whether the three big members — Italy, Germany and France — stick together."

In 2005, the three stuck together to get changes pushed through. But today, Berlin is no longer in the same leaky fiscal boat as Rome and Paris.

The stability and growth pact was agreed to in 1997, before the introduction of the euro, as a means of enforcing budget discipline. Germany was a driving force, fearful that its economy would be punished for the profligacy of other euro aspirants, like Italy.

But it was Germany's budget troubles that almost blew apart the pact five years ago, leading to a tussle among governments, the suspension of the rules for a period, a clash at the European Court of Justice and, ultimately, the dilution in 2005.

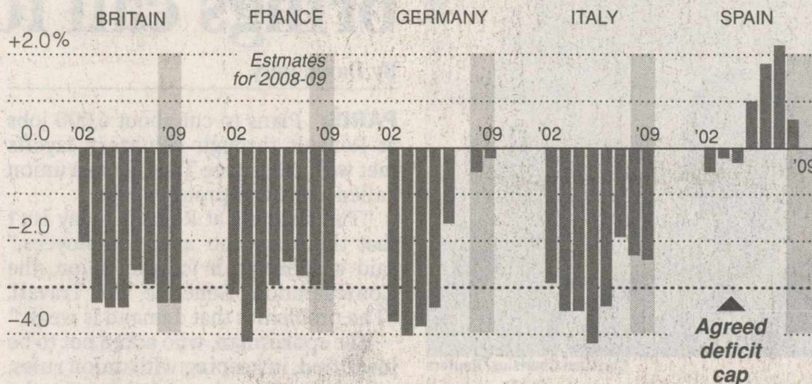
For some, the changes were seen as positive — allowing budget policy to play a more active role in resuscitating growth. For others, it was a warning that European governments would spend more and offer tax breaks they could ill afford.

In brief, the original pact restricted budget deficits to 3 percent of gross domestic product. If that level was exceeded, immediate corrective steps were to be taken. Governments could ultimately impose financial sanctions on peers who failed to take corrective action. There was also reference to keeping debt ratios at reasonable levels.

After the changes, the 3 percent limit on deficits remained intact, but exceptions were introduced. For example, sanctions could be averted in the event that an economy was actually shrinking or in a prolonged period of low growth; previously the exception was for a serious recession with GDP shrinking by 2 percent or more. Various forms of spending, like research, were not to be counted, while members were given two years, rather than one, to correct an overshoot.

Unbalanced budgets

As the largest European economies slow, budget deficits in several countries are in danger of breaching the agreed EU limit, 3 percent of gross domestic product.



Source: European Commission

Critics say the new pact has the same basic flaw as the previous one: It provides for coordinated action only when things go bad.

"The challenge seems to be that it is difficult for countries to use periods of good growth for strengthening underlying fiscal positions," said Johnny Akerholm, who played a coordinating role in EU policy this decade and is now chief executive of the Nordic Investment Bank. "In periods of good growth, the EU has no instruments to influence the individual countries."

France is the country most concerning budget watchers today, having put off budget-balancing during the fat years.

Now, "as we move into the downturn, the risk of a breach is very high," said André Sapir, a professor at the Université Libre de Bruxelles and former adviser to the European Commission.

President Nicolas Sarkozy of France enacted a series of tax breaks after entering office last year, while also pledging to bring the budget "close to balance" by 2010.

The European Commission's last forecast estimated that the French deficit would rise to 3 percent of GDP next year from 2.9 percent this year, but down from a peak of 3.6 percent in 2004. Those estimates will be revised at the start of November and analysts say that they expect them to be gloomier.

So far, Paris is holding the line — barely. Prime Minister François Fillon played down calls in August for a stimulus plan after GDP contracted, for the first time since 2002, by 0.3 percent in the second quarter.

Italy is also a worry, Sapir said, although for the moment, the finance minister, Giulio Tremonti, appears to be sticking to a tough line, pledging to lower spending in a country associated with budget overruns and creative accounting. The deficit is expected by the commission to rise to 2.4 percent of GDP next year from 2.3 percent this year.

Germany, meanwhile, is in an "interesting situation," Sapir added. It was supposed to be the litmus test for the new rules, but instead it shifted from pariah to model student, and hence "has room" for stimulus.

By contrast, Britain is in a tricky position as it tries to help consumers hit by falling home prices and rising food and energy prices. In one sense, it has a little more leeway — it cannot be financially sanctioned under the pact, as it has not adopted the euro. But it has made the same deficit commitments as the others and has already been warned by Brussels.

Within the euro area, the budgets of Ireland and Spain are deteriorating fastest as they suffer from a collapse in housing, which fueled growth for so long. But they used recent years of strong growth to balance their budgets, and have given themselves room to borrow more, or in the case of Spain to use tax breaks to stimulate activity.

Examples like those show that the pact, whatever its flaws, has benefits, most analysts say.

"It has had success in bringing debt levels down in some countries so that they can better face long-term challenges," said Barnes of the OECD. "It definitely provides an anchor that is not present in the U.S."