Pierre Werner Lecture
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FISCAL POLICY : A CHALLENGE FOR THE EUROPEAN MONETARY UNION

The subject you chose for this conference is most topical.

Monetary policy in the Eurozone is, by definition, common to all countries. But fiscal policies have remained national.

Since you cannot normally correct an asymmetric shock or a regional conjonctural divergence by changing the central monetary policy of the European Monetary Union (EMU), you could imagine acting through fiscal policy. That is indeed possible in a federal system like the US : budgetary transfers are automatically directed to depressed areas. But in the case of the European Union- where the European budget only accounts, for some 1% of GDP and is geared to structural funds and agricultural policy-, this tool is not available. In fact, the European Central Bank (ECB) is a Central Bank without a State.

Therefore, some form of coordination of national fiscal policies appears indispensable to ensure a smooth functioning of the Monetary Union in order to avoid deep economic divergencies which eventually can be incompatible with the common monetary policy.

This is why the Stability and Growth Pack is so essential.

With the benefit of the experience of the last seven years, we can attempt to answer the question: "are budgetary rules necessary and do they work? »

I shall organize my presentation around three ideas:

- the fiscal situation of a number of members of the European Union (the “fifteen”) is very serious and is evolving dangerously: this justifies that the Union be equipped (like many other countries) with pre-set budgetary rules;

- but, past experience forces us to recognize that the rules of the Stability and Growth Pact have not worked properly. Besides, their recent softening offers no guarantee that they will be more effective in the future;

- what can be the consequences for the Union and its member states of the continuation of current budgetary slippages?

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I) The Budgetary Situation Of Certain Members Of The European Union Is Very Serious. It Justifies The Existence Of Budgetary Rules:

1. The deterioration of the fiscal situation in Europe is striking:

The causes of this deterioration are rooted in recent history.

We see that the growth of public spending, since 1970, has been particularly strong in France, Italy, Spain and Germany.

Public spending in percentage of GDP

	1970	2003	Variations
Spain	23,6	39,3	+ 15,7
France	39,3	54,4	+ 15,1
Italy	33,5	48,5	+ 15,0
Germany	39,1	49,4	+ 10,3

(Table I)

By contrast, the public spending rate remained stable in the United Kingdom (around 42 %) as well as in the United States where it evolved from 32,4 to 35,9 % during this period of more than thirty years.

This push of public spending in real terms led to two phenomena which carry the seed of major economic consequences.

a) The tax burden has considerably grown:

Public revenues in percentage of the GDP

	1975	2003	Variations
Spain	18,8	35,8	+ 17,0
Italy	26,1	43,4	+ 17,3
France	35,9	44,2	+ 8,3

Source: OECD (see Table II)

In France, public revenues ("prélèvements obligatoires") account for more than 45 %[1] of GDP, which is ten percentage points more than in 1975, thus placing this country in the top league of the OECD. It is well known that, above a certain

[1] Of which 16 % for social security contributions. If one counts all forms of public revenues, the global figure is of the order of 50 % (see note 3 of table II).

threshold, too heavy taxes discourage private initiative and lead to outsourcing of activities in countries that are less imposed. Many are the examples of investors - national or foreign- who put off their projects in heavy taxed countries. In a world of free trade and capital movements, it is easy to imagine the damage that such a “fiscal exception” can entail, in term of growth, competitiveness and employment. All the painful consequences of these disincentives are not immediately apparent. But they will materialize eventually.

b) The second danger concerns the magnitude of fiscal deficits and of the related public indebtedness:

If taxation increases in relation to public expenditure, the latter tends to exceed the growth of budgetary revenues. It is, indeed, politically easier to increase public expenditure than to overtax citizens. The result of this phenomenon has been, over the last twenty years, a tendency towards a growth of fiscal deficits. Indeed, fiscal deficits have increased spectacularly world wide especially since the beginning of the eighties (see Table III).

While a country like France used to run rather limited fiscal deficits in terms of GDP (less than 1 % on a yearly average over the period 1974-1981), a strong expansion of those deficits has been observed in subsequent years. Thus, the yearly average of French fiscal positions since 1980 is a deficit of 3,5 % of GDP (2,5 % for Germany).

This trend has inevitably led to a dramatic increase in the public debt of industrialized countries (see table IV), increase that is all the more significant that inflation doesn't help anymore to reduce the burden of outstanding debt contrary to what happened in the past.

Italy, Belgium and Ireland have, in particular, seen a true explosion of their public debt during the seventies and the eighties. Their ratio of public debt to GDP has, indeed, exceeded 100 % in the early nineties.

But the "good pupils" have also tended to be contamined. Thus, in France, where public debt to GDP was below 20 % in 1980, the ratio is 65 % today, a trebling in real terms over twenty years. How could France -whose public indebtedness was traditionally moderate-, join, in less than two decades, the group of countries who have exceeded the 60 % alarm limit ? The answer is simple : by letting public expenditures and deficits slip year after year in an environment of less buoyant economic growth.

The negative consequences of this situation are obvious. On the one hand, public deficits have absorbed a growing share of private savings, which has consequently reduced financing resources available for private productive investment (crowding out). Table V shows that deficits of the general government have tapped, on a yearly average basis, some 40 % of French net private savings form 1980 to 2003. On the other hand, as table VI shows, the cost of servicing the public debt has grown significantly.

One realizes that budgetary authorities have lost a significant part of their flexibility since they have to allocate such large resources to servicing public debt. The general reductions of interest rates over the last years has, of course, tended to moderate the magnitude of this phenomenon. But we should never forget that markets will eventually sanction -through higher long term interest rates- systematic deficit spending policies.

It is well known that beyond a certain level (around 40 % of GDP), public debt becomes "unsustainable". Thus, a number of emerging countries have to generate each year primary surpluses (i.e. before interests) of the order of 4 % of their GDP in order to stabilize or reduce their public debt[2].

Lower interest rates have no doubt encouraged deficit spending over the last years[3]. But in an environment of slow economic growth, the real value of public indebtedness continues to increase. Accumulating, year after year, fiscal deficits of 3 to 4 % of GDP when growth hovers around 1 to 2 %, is a dangerous snowballing process. Furthermore, there is no guarantee that long term interest rates will remain permanently at the present low levels.

In this respect, one should have in mind the Domar theorem which states : "If the nominal interest rate is higher than the nominal rate of growth of GDP (which is the case of several European countries) the ratio debt/GDP will grow infinitely whatever the level of the deficit". In other words, inconsiderate borrowing destined to transfer on future generations of tax payers the cost of present current expenditures, leads to a deadlock in a world characterized by moderate growth, and positive real interest rates due to low inflation.

It is therefore necessary to correct the present situation and to reduce significantly budgetary deficits as well as public debt when the latter appears excessive. This action is all the more indispensable that the horizon is clouded by the massive financial consequences -yet to be properly calculated- stemming from the demographic decline of most industrialized countries especially in Europe. With aging populations (less working tax payers and contributors versus more entitlements), future public finance problems will only compound the consequences of fiscal slippages of the past twenty years.

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[2] The primary fiscal balance of the euro zone has significantly deteriorated over the past five years.

[3] Lower interest rates, which reduce the burden of debt service, should normally have led to a reduction of public expenditure and deficits. In fact, the fall in interest rates has been, in part, offset, in France, for example, by an increase of other public expenditures items. Other countries (like Spain, the United Kingdom, the Netherlands….) have better taken advantage of the lower interest rates (see Table I).

2. This situation justifies that the Union should impose on itself rules-based fiscal policies:

a) Budgetary rules seem necessary:

As the horizon of politicians is, often, limited to the next elections, it is difficult for them to conceive and enforce a medium term fiscal strategy. Cutting back public expenditure is never popular, because it reduces, by definition, the benefits and entitlements of a number of citizens even if it leads to a global betterment for the community at large. Reducing, year after year, public expenditure is obviously politically difficult.

This reality has led a growing number of OECD States to resort to "rules-based" fiscal policies. Such rules are meant to better contain deficits and public expenditure over the medium term and to stabilize or, if needed, reduce public indebtedness.

The common thread of the many legislations that have been voted in this field is that fiscal discipline -once it has been laid out by Parliament in a medium term framework- is easier to enforce steadily. Of course, new majorities can always undo what has been established earlier on. But experience shows that it is easier politically to reach "bi-partisan" agreements on fiscal codes of conduct, than to obtain year after year new austerity measures.

From this point of view, the rules contained in the Treaty of Maastricht and in the Stability and Growth Pact are in no way a specific and exceptional feature of the European Union.

Indeed, countries as Australia, New Zealand, Canada, Sweden, Netherlands, Switzerland, have adopted medium-term budgetary frameworks which have proven successful[4] and which not only did not damage the medium-term economic situation of the concerned States, but, on the contrary, have favored their growth. One has to explain to public opinion that uncontrolled fiscal deficits lead, eventually, to higher long term interest rates and to increased unemployment.

It seems to me that what has been useful and efficient for a number of countries is even more necessary for the States of a Monetary Union.

There is, indeed, an additional justification for a fiscal framework in a monetary zone. As monetary policy is, by definition, common to all members of the Union, and run by an independent Central Bank, fiscal policies must be consistent. If some

[4] See International Monetary Fund (Occasional Paper n° 225) : "Rules-based fiscal policy in France, Germany, Italy and Spain", by Teresa Daban, Enrica Detragiache, Gabriel di Bella, Gian Maria Milesi-Ferretti et Steven Symansky, Washington 2003.

members were allowed to run high deficits, this would entail consequences for the whole Union, all the more so if the slippages came from countries carrying a significant economic weight. Systematic deficit spending eventually leads to higher prices and interest rates, to a loss of competitiveness and therefore distorts economic and financial conditions in the Union.

Ultimately, if a member State of the Euro area were to run excessive deficits for a long time, and became, in the event, unable to service its debt, such a country could not count, as a result of Maastricht Treaty, on its Central Bank for the monetary financing of its obligations. Such a country would either be compelled to take drastic corrective actions or to default. The latter option could impact the soundness of the banking system of the country in question (with the risks of contagion this implies) and therefore could put pressure on the European Central Bank as a lender of last resort.

So, besides national reasons that justify prudent fiscal policies, there is a need for members of a monetary Union to behave consistently and in a mutually responsible way. This implies solidarity and the respect by all of common rules.

b) The thrust of European fiscal rules :

European norms are the combination of the Maastricht Treaty rules (signed on February 7, 1992) and those laid out, later on, by the Stability and Growth Pact (June-July 1997).

One should analyze how these rules complement each other and what are their respective justifications.

The Maastricht Treaty rules (fiscal deficits must not exceed a limit of 3 % of GDP, and public debt should not exceed 60 % of GDP) should be related to the history of EMU : the main objective, in the early nineties, was to determine the accession criteria for the future members of the Monetary Union. Some countries like Spain, Italy or Greece, were running, at the time, fiscal deficits well above 3 % of GDP. The norm was intended to encourage them into the convergence process. As for the countries whose public debt exceeded 60 % of GDP (Italy, Belgium…), the Treaty called on them to rein in their deficits (below 3 %) so that they could gradually, but visibly, come back to the 60 % norm.

Given the growth and price environment prevailing in Europe, those limits are internally consistent. They had the merit of laying out a simple framework for convergence which, eventually, has been a great success. Let us not forget that Southern European countries have all, eventually, managed to meet the Maastricht criteria and to join EMU.

The creation of the euro in 1999 has led to a common monetary Union in Europe. This has eliminated the nagging problem of exchange rate fluctuations among members of the Union. In turn, this has led to an intensification of trade relations within the zone and to the almost elimination of interest rate differentials which used to penalize the countries perceived by the markets as too far away from economic convergence (see graph VII).

The Stability and Growth Pact -which lays out the procedure of "excessive deficits"- should be understood in a different perspective. Its objective is not intended to establish accession criteria but to determine the rules which, in the medium term, will ensure that member-states fiscal discipline will be pursued after the accession and the creation of the euro. It is in this context that the Pact prescribes that member-states must reach a balanced fiscal position over the cycle.

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What I have just said about the Union of Fifteen countries is also true, in my opinion, for a number of new members of Central Europe.

The fact that Hungary has registered over the past four years accumulated deficits of almost 23 % of GDP (entailing an increase of public debt of 5,4 points of GDP), and that the respective figures are 16,8 % and 6.9 points for Poland and 27,4 % and 10,2 points for the Czech Republic, shows that strong fiscal corrective actions are called for in those countries

II) BUT EXPERIENCE LEADS TO THE CONCLUSION THAT THE EUROPEAN BUDGETARY RULES DIDN'T WORK WELL. THEIR RECENT SOFTENING OFFERS NO GUARANTEE THAT THEY WILL BE MORE EFFECTIVE IN THE FUTURE:

1. Why didn't the system work well?

It is not, in my opinion, because it contained a fundamental flaw.
Requiring European States to ensure a fiscal balance over the cycle, seems, indeed, a prudent rule. Some could object, nonetheless, that such a rule would tend to lead in the long run to an elimination of public indebtedness (because of the positive trend for GDP growth), which would have an unnecessary restrictive effect on the economy and would hamper an optimal allocation of savings. To this argument -that has some validity in theory- one can object, however, that European countries fiscal horizon is so clouded by the consequences of demographic changes on long term public commitments that it is only prudent to try and build some margins for future, inevitable, increases in indebtedness. In this respect, requiring an "over-the-cycle fiscal balance", as laid out by the Pact, especially for countries whose public

debt exceeds 40 to 50 % of GDP is, for the future, a good house-keeping measure[5]. Many are the countries who, outside EMU, abide by such rules.

But if it is not the basic concept that was at fault, it was the interpretation and the application of the rules that were the source of the problems which, following the "excessive deficits " procedures for France and Germany, led to the stalemate and the crisis of 2004.

I believe that five factors explain this failure.

a) Automatic stabilizers should operate both ways:

It is normal that, within certain limits (and in this respect, the 3 % reference is an acceptable order of magnitude, even if it implies an inevitable element of arbitrariness), fiscal deficits deteriorate when the economy slows down. But what is not normal, is that in periods of growth, the additional revenues are not used to reduce deficits significantly more than has been the case in the past for a number of member states.

France and Germany are typical "counter-examples" as the following table shows:

		1998 %	**1999 %**	**2000 %**	**2001 %**	**2002 %**	**2003 %**	**2004 %**
France	GDP growth	3,5	3,0	3,4	2,0	1,3	0,9	2,1
	Public deficit/GDP	- 2,6	- 1,8	- 1, 4	- 1,5	- 3,1	- 4,2	- 3,7
	Structural deficit/ GDP	- 2,1	- 1,5	- 1,8	- 1,9	-3,1	- 3,3	- 3,0
Germany	GDP growth	2,0	1,8	3,0	0,8	0,2	0	1 ,0
	Public deficit/GDP	- 2,2	- 1,5	- 1,4	- 2,8	- 3,6	- 3,8	- 3,7
	Structural deficit/ GDP	- 1,7	- 1,3	- 2,0	- 3,5	- 3,5	- 2,9	- 2,6

Thus, over the whole cycle (1998-2003), these two countries, far form reaching a "position close to balance" as required by the Pact, have respectively accumulated 14,6 % (France) and 15,3 % (Germany) fiscal deficits in terms of GDP. The basic idea of any "discipline oriented" fiscal framework, i.e. that economic expansion should lead to significant fiscal improvement, has not been applied by the largest member-states of EMU. The heated debate that took place in France a few years ago, on the use of revenue surpluses (the "cagnotte" or "kitty"), shows how the authorities and the general public are still far from reaching a consensus on this crucial subject[6].

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[5] On the fiscal impact of aging populations , see Peter S. Heller :"Who will pay ?" (IMF 2003).

[6] If public Administration were to compute -as corporations do- the total amount of their contractual liabilities and those that will be contracted in the future in the field of pensions, one would observe figures of total liabilities (net of contributions) much higher than those reflected in usual indebtedness statistics. This is not too serious a problem in a situation of constant demography. But with aging populations, wisdom requires to compute and provision these future spending obligations (see Peter Heller).

The same phenomenon can be observed in Italy where the structural deficit (calculated without conjonctural influences) has moved from -1.6% in 1999 to –3% in 2000 while economic growth rate increased from 1.7 % to 3.2 %.

The more virtuous example of Spain helps to understand how the cycle can be used, in fiscal terms, without endangering economic growth.

		1998 %	**1999 %**	**2000 %**	**2001 %**	**2002 %**	**2003 %**	**2004 %**
Spain	GDP growth	4,3	4 ,0	4,1	2,7	2,7	2,9	3,1
	Fiscal balances	- 0,6	- 1,2	- 0,8	- 0,1	- 0,3	+ 0,3	- 0,3
	Structural positions	- 2,5	- 1,1	- 1,6	- 0,7	- 0,1	+ 0,7	+ 0,1

The experience described above shows that the 3 % Maastricht criteria has been seriously misinterpreted. Governments have considered it as a target, below which they feel comfortable, whilst the limit should only operate "in bad weather". It is during periods of growth that EMU member-states should -better than has been achieved in the past-, reduce deficits well below 3 % or generate surpluses. Letting the automatic stabilizers operate both ways should become an obligation (see, for example, the case of the Netherlands). In this respect, the deficits incurred by France and Germany from 1998-2000 -years of reasonably good growth- compound the present fiscal situation and have made it all the more difficult to rein in imbalances in years of declining activity, because margins of maneuver have not been built during the "good years". In other words, it is during the periods of expansion that fiscal surveillance should show its muscle, more than in times of recession.

b) Structural deficits should be reduced:

Hence, at the end of 2002, the Commission has given more importance to the cycle in its proposals to adapt the Pact. It has stressed the need to let the stabilizers operate symmetrically. In this respect, it has proposed an annual target to reduce structural deficits, which is indeed the only proper way to implement the medium term stability objective. Table IX shows that, except for Japan, the United States, and Italy, France runs the highest structural deficit among large OECD countries (- 3 % of GDP in 2004) followed by Germany (- 2,6 %). It is therefore indispensable to engage in a policy geared to the reduction of those deficits. This is of the essence, not only for the sake of the Pact, but for the future of the public finances of the interested countries and their ability to face the challenges for growth and employment in a open and non-inflationary environment.

c) It is necessary to better adapt fiscal policies to the nature and the sources of the problems experienced by different members-states:

This “case by case” adaptation is, in principle, taken into account in the national stability programs. But this endeavor should be more systematically followed up by the Union. The recommended fiscal adjustments should be more "tailor-made" and influenced by factors like the level of public debt or the burden of public spending and its nature (current versus investment) of individual member-countries.

Thus, a country like France which is characterized, as shown above, by a very high level of public spending and taxation, should decisively engage in reducing public expenditures and improve the efficiency of public administration.

Countries like Italy, Belgium, Greece who have very high levels of public debt (respectively in 2004: 105,8 %, 95,6 % and 110,5 % of GDP) well beyond the European average, should also be required to carry out a more significant reduction of their structural deficits.

d) One should shape the fiscal strategy in a longer term demographic perspective :

The aging of European populations is bound to increase the burden of pensions and healthcare. These impacts and their timing vary from country to country. For example, table X, computed by the Ecofin, shows that in the "heaviest" year of the central scenario -2030 for France and Italy, 2040 for Germany, 2050 for Spain- the public expenditure "overruns" vis a vis 2000 stemming from pensions alone, will be, on average, of a magnitude of 4,5 % of GDP for that group of countries (4 % for France, 5 % for Germany)….

If structural reforms (lengthening of retirement age, increases in contributions, reductions in entitlements,…) cannot, by themselves, resolve all the problems, it is prudent to consider that the public finances of those countries will have to make some additional contribution. This means that it is imperative to "mend" fiscal policies well ahead of the most critical years, so that, when times come, debt sustainability is not put in jeopardy.

Therefore, taking into account -as countries like Australia, New Zealand and United Kingdom do systematically- the demographic evolutions on the long run is an indispensable exercise. This would perhaps facilitate the educational process aimed at getting public opinions better aware of the need for medium term fiscal discipline.

e) Lastly, European budgetary discussions should be "depoliticized" :

On several occasions, the Commission has, without success, recommended to the Council of Ministers to trigger early warning or excessive deficits procedures.

The events have shown that the Commission had been right but that, because of the more "political" stance of the Council, fiscal situations had been allowed to deteriorate. Had the Commission been followed, fiscal corrective actions might have been taken earlier and the Pact would have been better observed.

With hindsight, it appears also that member-states have often based their budgetary projections on too optimistic growth assumptions. This bias affects the European procedures. One should pay much more attention to this issue. A "rule of prudence" should be established and followed up meticulously (perhaps by a group of independent experts).

Member-states should not consider the Stability and Growth Pact as a sort of external imposition. They have all approved the Pact and should, therefore, feel responsible for its implementation. A number of democratic states abide, on a voluntary basis, by similar (and generally stricter) rules. It is time that governments and parliaments make those rules really "theirs" and, if needed, adapt them to their own situations as long as this "personalization" doesn't weaken the Pact (see, as a good example, the case of the Netherlands where rules are stricter than those of the Pact).

2. The softenings introduced in the Stability and Growth Pact, in March, 2005, do not guarantee a greater efficiency for the future.

Some adjustments introduce more realism and flexibility into the rules. Thus, the Council has made a distinction between countries with low debt but with high growth potential and countries with high debt ratios or with low growth potential.

For the former ones, the medium-term deficit (over the cycle) can reach one percentage point of GDP, whilst for the latter the accounts should be in balance or in surplus. This modification is justified[7], notably for the countries of Central Europe whose potential growth is strong and who have high needs of catching up in infrastructure.

But what seems questionable is the way the 3 % criterion was watered down. Henceforth, member states can depart from this criterion in case of stagnation (and not, as previously, in case of a recession). Besides, the Commission will have to «assess if the deficit is higher than the public investment » (but, we know that the definition of public investment is elastic) and will have to take into account "all other relevant factors" among which feature the spending on research, development and education -which amount to 5 % of GDP in the euro zone !- as well as the budgetary efforts for “aid, international solidarity and the unification of Europe”…. The "relevant factors" will thus easily allow to exceed the 3 % criterion. Besides, the time frame for correcting actions is doubled, moving from one to two years.

[7] See Philippe d’Arvisenet : Le Pacte de Stabilité et de Croissance, Sociétal, Juin 2005.

The most important measure, in my opinion, namely, to take binding provisions to enforce a symmetric application of the Pact (i.e. to get States accumulate surpluses or at least fiscal improvements in the upper parts of the cycle) was not taken. The Council only indicated that the adjustment efforts should be more marked in periods of strong growth, but this appears as a pious wish.

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III) WHAT CAN BE THE CONSEQUENCES FOR THE UNION AND FOR ITS MEMBERS OF THE CONTINUATION OF CURRENT BUDGETARY SLIPPAGES?

1. The March 2005 reform of the Pact contributes to weakening the credibility of fiscal sanctions:

Experience has shown that in periods of high growth, the Pact had not incited the two largest countries of the Union to improve significantly their fiscal positions.

It also showed that in periods of low growth, the rule on “excessive deficits” was only compounding the political difficulties by adding budgetary restrictions to a deteriorated economic situation. The system was not able to stand these pressures. « Peer pressure », especially for large States, quickly reached its limits.

With the recent softenings, the political risks of tension will be reduced to some extent. The wide definition of the "relevant factors" leaves, indeed, the door open to significant overruns of the target. But, at the end of two years of overruns, will the Commission have the authority -which it never really had- to enforce credible penalties? History will tell.

Therefore, it remains to hope that States will come themselves to the conclusion that it is of their own interest, and of the future generations, to abide by budgetary standards and indebtedness ratios which are reasonable and sustainable.

But, in a certain sense, the existence of the euro does not facilitate such a "national appropriation" of budgetary discipline.

Indeed, in the old days, budgetary disorders were rather quickly translated in price rises, in a deterioration of the current account, and, eventually led to contractionary economic and monetary policies, not to mention devaluations.

The adjustment mechanism does not work in the same way nowadays for EMU members. Certain States can run higher inflation (especially higher labor unit costs) than their neighbors as a result of a systematic policy of stimulation of public demand. But the sanction doesn’t take immediately the form of higher interest rates or of a depreciating exchange rate. It results in a loss of competitiveness, a fall in exports and an increase in unemployment and entails eventually the need for lower wages and standards of living. The problem gets even worse when the country in question witnesses a loss of competitiveness because of structural rigidities.

However, for the time being, the euro "protects" the Union: the currency remains strong, imported inflation is inexistent and therefore dampens price increases, and interest rates continue to take advantage of the status of a large international currency. For the countries whose costs have significantly increased, the loss of competitiveness (due to the implicit reevaluation of their exchange rate) and their eroded growth potential are the essential dangers.

Then, if it is not the legal mechanism of the Pact that may counter budgetary slippages, can the market play that role?

2. The sanction by the market of budgetary deviations is slow to show up:

It has indeed been relatively benign since the start of the euro in 1999 and until recently.

The creation of the euro tended to erase intraeuropean spreads. Before the single currency, it was observed that a negative spread in terms of fiscal deficits or public debt vis a vis Germany entailed a significant cost (Thus, the spreads on 10 years Spanish and Italian bonds vis à vis the bund were respectively around 400 and 600 basis points in 1995). This effect has been considerably reduced with the convergence process that led to the euro and the elimination of exchange rate risk. Conversely, a more virtuous budgetary behavior of a small country is hardly significantly rewarded by the market. Thus, Finland, the fiscal performance of which is exemplary (fiscal surpluses over the last eight years and moderate public debt), had only (July 2005) some 25 basis points of advantage on its spreads with regard to Italian and Greek bonds, and was almost at par with bunds. (see graph VII and Table VIII)

Besides, the deterioration of the budgetary situation of Germany and France, since the creation of the Euro, has not really penalized the issues of these two States, although it must be noted that the weakening of the Stability and Growth Pact, in March 2005, probably contributed to an increase in European yields (see Table VIII). But spreads have reduced again in the summer for countries like Germany, France and Spain while they increased somewhat for Italy and Greece (see Table VIII and Table XI).

What are the reasons of this relatively weak discrimination -at least up to a recent date- by the markets in the context of escalating debt ratios ?

I see the following:

1. First of all, the abundance of global liquidity –in part as a consequence of the US accommodative monetary policy- has contributed since the end 2000 to a worldwide reduction of spreads. This evolution -visible on emerging markets debt instruments- has also influenced the less well rated securities of the euro zone. However, the present tightening of US monetary policy could change this trend.

2. Secondly, operators value highly the size and liquidity offered by a bond market. Therefore, a small country which has good records in terms of budgetary balance and public indebtedness is, to some degree, penalized by investors because of the reduced volume of its securities and of the liquidity offered by its local market. The "reward" that it should receive because of fiscal virtue remains thus modest. The sheer size of the three major countries' public debt influences the individual spreads of smaller countries.8

3. Thirdly, if "deviant" budgetary behaviors by small or large countries have also been up to now relatively little penalized, it is maybe that the euro - common currency- tends to mask the negative peculiarities of such or such an issuer. Which amounts to saying, in a way, that the market does not really believe in the "no bailing out" rule adopted in Maastricht. However, recently, there has been a certain move towards a widening of euro zone spreads (see graph VII bis).

4. Fourthly, the large countries, which are also less open to the outside world than the small ones, are more tempted by discretionary budgetary policies to stimulate activity. But, as they are large and relatively better immunized than the small ones against the risks of import leakage, and that they benefit from the effect of size (1. above), they are, in fact, somewhat spared by markets.

5. Finally, market economists have not the same definitions of "sustainable" budget deficits and public debt as those contained in the Stability and Growth Pact. They have a longer horizon and tend to worry only after indicators significantly deteriorate. In other words, their "alarm bell" is not geared to the 3 % and the 60 % data. The trigger is rather slower to show up.

One can add that the fact that the ECB introduces no differentiation based on fiscal performance among the Treasury instruments that it accepts as collateral for its money market operations, contributes to the limitation of spreads of the euro zone[9].

But, all this does not mean that the alarm bell will always remain silent. If the budgetary situation, notably that of the large States, continues to deteriorate, a

[8] The public debt (as a percentage of GDP) of Germany (26,7 % of the Euro aera), of Italy (26,6 %) and of France (19,8 %) amount to almost three quarters of the total public debt of the euro area.

[9] The President of the ECB declared in a recent hearing at the European Parliament that the Council of Governors had rejected the idea of « selective ratings » for such collaterals (Meeting on 23-24 May 2005 – Economic and Monetary Committee).

moment will come when markets will eventually react by raising the risk premium. It would then be the euro that would deteriorate both from the point of view of the exchange rate and interest rates. It is under such circumstances that the “contagion” effect on States who remained more “virtuous” would become manifest. It is to be feared, indeed, that the satisfactory budgetary behaviors of certain States -especially the small ones- would continue not to be rewarded as much as the economic rationality would justify it, because of the "all-embracing" effect of the euro.

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These considerations make it even more indispensable to enforce an enlightened common policy of budgetary discipline -coupled with the necessary, and hopefully coordinated, overdue structural reforms- within the Union. Otherwise, in cases of fiscal slippages by the large countries, the risk is that we would be witnessing a "pooling" of the negative effects of these slippages to the detriment of those member states having played by the rules of the game. It is the solidarity and thus the consistency of the Monetary Union which would be at stake.

Eventually, what is important is to rekindle economic growth in Europe (which would in itself help to restore budgetary conditions). In order to reach that objective, governments must endeavor to eliminate all types of rigidities that hamper the development of our economies. And they must regain control over public finances. No one can even envisage that Central governments can continue to expand public expenditures (as many have done over the last years) at a rate that exceeds that of GDP.

Some argue that "there are no institutions and instruments that enable countries to coordinate their economic policies effectively". [10] I personally believe that such coordination is possible but that it will require not only strong political will, but also a true political dimension.

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[10] See, for example, the article of Wolfgang Munchau : "The Eurozone may remain a "club within a club" , "Financial Times", 5th September, 2005