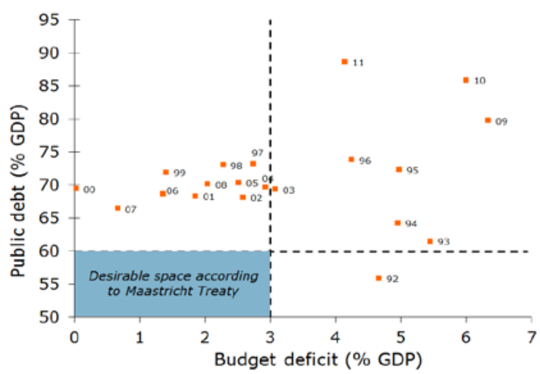
Maastricht Treaty turned 20, hooray?

Macro Comment 12/14

Shahin Kamalodin

The 20th anniversary of the Maastricht Treaty went largely unnoticed due to the euro crisis. Now the officials have come up with stricter fiscal rules to avoid a repeat of this crisis. Only time will tell whether the taken steps are sufficient to ensure fiscal sustainability.

Figure 1: Eurozone public finances



Source: IMF, Rabobank

The Maastricht Treaty turned 20 yesterday (it was signed on February 7, 1992) but most people failed to notice. Given the current debt crisis that has grappled the eurozone, the European leaders must be forgiven for not unleashing fireworks on this date. Looking purely at the two famous goals of the Treaty, namely budget deficits below 3% of GDP and debt-to-GDP ratios below 60%, one can safely argue that the Maastricht Treaty was a failure. Figure 1 illustrates that over the past 20 years, there was not a single year that the eurozone as a whole met the Maastricht Criteria. Disturbingly enough, debt ratios jumped over the 60% target one year after the Treaty was signed and never managed to return below this threshold.

To address the shortcomings of the Maastricht Treaty, the European leaders decided to impose stricter rules to attain sustainable public finances and avoid future debt crises. More specifically, governments undertook to overhaul the fiscal governance system of the eurozone mainly through two elements: the reformed Stability and Growth Pact (we name it SGP+), and the so-called 'fiscal compact'. So let's take a look at each policy proposal in turn.

SGP+

The reformed SGP still includes a reference value for the upper limit of the government deficit of 3%. However, governments are also obliged to follow so-called 'medium-term budgetary objectives' (MTO), which aim to guarantee debt sustainability by demanding that every country reports a cyclically adjusted (structural) budget deficit of at most 0.5% of GDP. The structural deficit has been chosen to ensure that fiscal policy does not turn pro-cyclical. It is important to note that this deficit criterion has an escape clause as it allows for a deviation from target "*in case of an unusual event outside the control of the Member State concerned which has a major impact on the financial position of the general government or in periods of severe economic downturn for the euro area or the Union as a whole*".

As far as the debt ratio is concerned, the 60% reference value remains intact as well. However, while the debt criterion was neglected under the old regime, the SGP+ explicitly requires member states to reduce their debt ratios to achieve the 60% target. In specific, the new rule demands that member states reduce their debt ratio in excess of the 60% benchmark by 1/20 each year. Failure to comply with this will trigger an Excessive Deficit Procedure (EDP) even if the country meets its 3% deficit criterion.

Maastricht Treaty turned 20, hooray?

A final crucial aspect of SGP+ is the enforcement of the new fiscal rules under the EDP, meaning that more 'automaticity' is enforced. In case of breach of agreement, member states can only amend the European Commission's decision to impose a fine with a qualified majority before it becomes effective. This so-called reverse qualified majority (roughly 74% of the votes in the Council of the European Union) ensures that there is a much higher degree of automaticity in the EDP than it was before.

Fiscal Compact

The fiscal compact, a term coined by the ECB's president, does not add much to the details laid out in the reformed SGP and is mostly meant to ensure a stricter enforcement of the fiscal rules. The fiscal compact refers directly to the 0.5% structural budget balance target but includes no additional requirements for the contracting parties. The major achievement of the fiscal compact is that countries need to implement the fiscal rules under national law, preferably by amending national constitutions. Moreover, following the official agreement of governments regarding the fiscal compact (due for the March EU summit), any country gets the right to sue another country in the European Court of Justice if there is reason to believe that the latter has not complied with the need to incorporate the rules into its national legislation. Thus, at least in principle, each government has the ability to enforce an EDP.

Will the new fiscal framework be more successful than the Maastricht Treaty?

The real test of the new fiscal framework will be the achievement of its goals without it leading to adverse economic outcomes that could potentially discredit the whole new system of fiscal governance. Criticisms are bound to rise if the new system were to result in a pro-cyclical fiscal policy over the economic cycle. Obviously, making cyclical corrections to the budget balance is more art than science. Given that our ability to compute structural budget balances in real time is quite limited, it is unsure how much merit such a deficit rule will have. Another difficulty is how we can assess prudence of fiscal policy in a given period. If a country is going through a housing market boom (like Spain or Ireland) then will a 0.5% of GDP structural budget deficit be sufficient? Clearly, with the benefit of hindsight, we can argue that in such a circumstance, a government must post a larger budget surplus than what would be consistent with SGP+. But can the EC or other member states enforce this? If they cannot, then there is a good chance that a crashing housing market/banking crisis will lead to a widening deficit over and above 3% of GDP. In such a circumstance, the country may avoid a fine by using the above-mentioned escape clause. The result will be a ballooning debt ratio that can eventually result in loss of market trust and subsequently a full-blown debt crisis. If, on the other hand, a fine is imposed, then governments cannot allow the automatic stabilisers to operate in full while discretionary fiscal stimulus measures remain out of the question. Such rigidity will deepen the recession and may even push the country further towards insolvency.

In any case, the amendments to the Maastricht Criteria were needed given the failure of this Treaty to address unsustainable public finances. Governments have taken the right steps by making the new system more binding than the old one, as rules are spelled out in more detail, leaving less room for interpretation and consequently for political interference. The higher degree of automaticity for enforcement of rules is also a welcome step. At the same time, the new fiscal framework in the eurozone may not be the silver bullet the European leaders are looking for. To be sure, only time will tell whether the newly enacted fiscal rules will put the Eurozone, once and for all, on a solid fiscal footing.

Shahin Kamalodin

Maastricht Treaty turned 20, hooray?

Rabobank

Rabobank Economic Research Department

	Tel.	E-mail:
Chief economist	+31 30 21	
Wim Boonstra	66617	W.W.Boonstra@rn.rabobank.nl
International Economic Research		
Allard Bruinshoofd*	63272	W.A.Bruinshoofd@rn.rabobank.nl
Macro		
Shahin Kamalodin	31106	S.A.Kamalodin@rn.rabobank.nl
Tim Legierse	62677	T.Legierse@rn.rabobank.nl
Michiel Verduijn	30522	M.P.Verduijn@rn.rabobank.nl
Country Risk		
Erwin Blaauw	62648	E.R.Blaauw@rn.rabobank.nl
Fabian Briegel	64053	F.Briegel@rn.rabobank.nl
Jeroen van IJzerloo*	62406	J.IJzerloo@rn.rabobank.nl
Herwin Loman	31105	H.Loman@rn.rabobank.nl
Reintje Maasdam	31403	R.Maasdam@rn.rabobank.nl
Ashwin Matabadal	61601	A.R.K.Matabadal@rn.rabobank.nl
Reinier Meijer	31568	R.Meijer@rn.rabobank.nl
Anouk Ruhaak	64860	A.N.Ruhaak@rn.rabobank.nl
National Economic Research		
Hans Stegeman*	31407	H.W.Stegeman@rn.rabobank.nl
Macro		
Ruth van de Belt	60143	R.Belt@rn.rabobank.nl
Maarten van der Molen	64214	M.T.Molen@rn.rabobank.nl
Danijela Piljic	31104	D.Piljic@rn.rabobank.nl
Anke Struijs	31408	A.C.A.Struijs@rn.rabobank.nl
Theo Smid	67599	T.H.Smid@rn.rabobank.nl
Paul de Vries	30172	Vries.P@rn.rabobank.nl
Regional		
Rogier Aalders	31393	R.Aalders@rn.rabobank.nl
Cynthia Briesen	31411	C.C.Briesen@rn.rabobank.nl
Frits Oevering	64439	F.J.Oevering@rn.rabobank.nl
Anouk Smeltink-Mensen	66404	A.H.H.M.Smeltink@rn.rabobank.nl
Willem van der Velden*	62478	W.Velden@rn.rabobank.nl
Financial Sector Research		
Yvette Jörissen	64931	Y.M.Jorissen@rn.rabobank.nl
Dick Scherjon	31405	D.P.Scherjon@rn.rabobank.nl
August Sjauw-Koen-Fa	31406	A.R.Sjauw@rn.rabobank.nl
Nicole Smolders	79108	N.M.P.Smolders@rn.rabobank.nl
Leontine Treur	67084	L.Treur@rn.rabobank.nl
Bouke de Vries*	61195	Y.B.Vries@rn.rabobank.nl

**Head*