Box 8

THE LEGAL FRAMEWORK FOR ENSURING SOUND FISCAL POLICIES IN EMU

The provisions of the Treaty establishing the European Community and the Stability and Growth Pact are intended to ensure sound fiscal policies – a precondition for sustainable economic growth – and to support the Eurosystem's independent monetary policy, which aims to maintain price stability. Such provisions thereby promote a smooth functioning of Economic and Monetary Union (EMU), in which a single monetary policy coexists with national fiscal policies.[1]

Article 101 of the Treaty prohibits the provision by the Eurosystem of overdraft facilities in favour of Community institutions or bodies, governments and other public entities, as well as the direct purchase by the Eurosystem of debt instruments issued by such entities. This provision is intended to sever the direct link between monetary policy and fiscal policy and, in particular, to prohibit the monetary financing of government deficits, which in past decades has contributed to excessive monetary growth and inflation in some countries. In accordance with Article 21 of the Protocol on the Statute of the European System of Central Banks and of the European Central Bank, the Eurosystem may still act as a fiscal agent for public entities. Moreover, the aforementioned prohibition does not apply to publicly owned credit institutions, which, in the context of the supply of bank reserves, are given the same treatment as private credit institutions.

Article 102 of the Treaty prohibits measures establishing privileged access by Community institutions or bodies, governments and other public entities to financial institutions, unless this is based on prudential considerations.

According to Article 103 of the Treaty, neither should the European Union be liable for or assume the commitments of governments or public entities, nor should a Member State be liable for or

1 The Stability and Growth Pact consists, principally, of (i) Council Regulation 1466/97, as amended by Council Regulation 1055/2005, on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, and (ii) Council Regulation 1467/97, as amended by Council Regulation 1056/2005, on clarifying and speeding up the implementation of the excessive deficit procedure.

assume the commitments of another Member State. This so-called “no bailout clause” is intended to ensure that Member States remain ultimately liable for their own borrowing. Consequently, investors should take this into account in their pricing of the debt instruments issued by different euro area countries.

The most basic rule of fiscal policy, enshrined in Article 104 of the Treaty and the secondary legislation of the Stability and Growth Pact, is that Member States should avoid excessive government deficits. As a rule, a general government deficit in excess of 3% of GDP is considered excessive in the sense of the Treaty and the Stability and Growth Pact. However, exceptions may be allowed if the breach of the reference value is exceptional, small and temporary.[2] A general government debt-to-GDP ratio above 60% is excessive unless the debt ratio is diminishing sufficiently and approaching the reference value at a satisfactory pace. When an excessive deficit is deemed to exist, the Member State concerned is subject to an excessive deficit procedure. This consists of a sequence of steps aimed at ensuring that the excessive deficit is corrected in a timely manner.

In the light of the current, unfavourable macroeconomic conditions, as well as the various fiscal stimulus measures adopted in recent months, a large number of Member States are expected to breach the 3% reference value for the government deficit ratio. In these cases – as indeed in all cases – a full application of the provisions of the Treaty and the Stability and Growth Pact is warranted. Closer scrutiny of the fiscal policies of Member States with excessive deficits and their prompt correction are important to reassure investors and the public at large of governments’ commitments to return to sound fiscal positions as soon as possible in order to ensure sustainable public finances. An unflinching commitment to the existing legal framework is thus all the more necessary in the light of the significant, additional financial commitments recently undertaken by governments in response to the current crisis.

2 An excess over the reference value resulting from a severe economic downturn may be considered exceptional in the case of negative GDP volume growth or an accumulated loss of output during a protracted period of very low annual GDP volume growth relative to its potential. Other relevant factors, particularly relating to the medium-term economic and budgetary position, the level of government investment and contributions to European policy goals, may also be taken into account. However, in order not to be deemed excessive, a breach of the reference value should, in all cases, remain small and temporary.