

**Remarks by John Bruton, former Taoiseach and Distinguished Fellow, Center for Transatlantic Relations, Johns Hopkins University, at an event of the Dublin Chamber of Commerce, in DIT Cathal Brugha Street, embargoed for 8am 14 December 2011.**

### THE EURO AREA FISCAL COMPACT

A new fiscal compact was announced on 9 December by the Euro area Heads of Government, as a means of protecting the stability and integrity of the Economic and Monetary Union, and of the European Union as a whole.

This is a vitally important goal, especially for Ireland which has gained more than almost anybody else in terms of market access, funds, and influence since it joined the European Union in 1973.

It is most important for Ireland that this fiscal compact be credible with the markets, and also understandable by the electorates of all 27 EU member states.

### AUSTERITY WAS COMING ANYWAY, BECAUSE OF THE AGEING OF EUROPEAN SOCIETIES.

A fiscal crisis in Europe was always on the cards around now, even if there was no single currency, because of the ageing of the European population.

Repeatedly, the European Commission has produced reports that said that, with unchanged policies, the debt to GDP ratios of many European states were going to reach 500% by 2050, simply by virtue of the increased size of the likely retired elderly population relative to the working age population.

During the boom, these reports were ignored by bankers, bank regulators, bond market participants, Finance Ministers, and political parties.

But if you want to understand the rationale for German attitudes today, you have only to look at the prospective ageing of its population.

Germans are worried that the savings they have put aside for their retirement will be devalued by inflation generated by excessive monetary easing by the European Central Bank, or by fiscal irresponsibility by other European states that are unwilling to balance their current budgets.

Critics of Germany do have a point when they say that, in the short term, Germany is asking a lot of some other euro area countries (like Italy and Greece) when it demands that they must suddenly become more competitive, increase their exports, and thereby earn the money to pay off their debts when, at the same time, their major market (Germany) is retrenching and reducing its demand for imports.

But the motivation for the German caution is the ageing of their own population, as much as it is fear of a repeat of the hyper inflation of the 1920's. And Greece and Italy also face the

ageing of their population too, so they would have had to retrench anyway, whether Germany insisted on it or not.

It is also important to keep a sense of proportion about “austerity”.

Admittedly expectations and prices have risen in the meantime, but austerity in 2012, is not quite the same as austerity was in the 1930’s , or even the 1980s, because almost all European countries are starting from a much higher income level that applied in the 1930’s or in the 1980’s.

### IT IS IMPORTANT TO RESPECT BASIC ARITHMETIC

It is also important to respect basic arithmetic.

For example, Ireland could not expect to have a welfare state as generous as that of Sweden, at tax levels similar to those of the United States.

As the late Garret FitzGerald pointed out on many occasions, and it did not add much to his popularity, Ireland is not, overall, a heavily taxed country. Pay, benefit , and pension levels paid from public funds are also higher than those in many other EU countries for comparable situations.

A choice about the distribution of benefits and burdens has to be made, and these are the most difficult questions of all. They are the ones politicians, who are usually trying to build the widest possible coalitions, prefer to avoid if they can.

During the boom these questions were easily avoided by borrowing, and by funding permanent expenses with temporary revenues. That is now over.

Even if the EU had no fiscal rule, the markets have now woken from their long slumber, and are demanding that those, to whom they lend , show how they will balance their books, and repay what they owe when it is due.

In that sense, the new EU fiscal compact is almost superfluous, in that markets will be imposing discipline anyway, euro or nor euro, pact or no pact, Britain in or Britain out.

The choice is between slow, negotiated, and slightly less destructive austerity, imposed by the EU compact, or fast, and much more destructive, austerity imposed by the markets.

Therefore, I argue that it is best for Ireland that there be strong and credible EU rules. It is important, however, that these rules be as operational as possible, as credible as possible and as understandable as possible.

In that spirit, I raise one or two questions about the detail of the proposed compact.

### HOW, AND BY WHOM, WILL THE NEW STRUCTURAL DEFICIT RULE BE INTERPRETED?

In paragraph 4 of the EU leaders statement, they say that the annual structural deficit shall not exceed 0.5% of GDP and that that this rule shall be introduced into member states legal systems at “constitutional or equivalent level”.

This is separate from the Excessive Deficit Procedure, under Article 126 of the existing EU Treaties, which provides for fines if deficits exceed 3%, and which is being strengthened under proposals that come into force this week. It is also separate from other changes, which require no Treaty or constitutional change, which will penalise countries for excessive debts as well as excessive deficits, and which will require countries to reduce debts progressively by a fixed amount each year

This 0.5% provision is something new and different, not published before, which is to be introduced into the domestic constitutional arrangements of all member states.

The concept of a structural deficit (of 0.5% of GDP) is different from the 3% limit in the Stability and Growth Pact.

If this part of the pact is to be understandable, workable, and enforceable, one must ask the key question.

How easy will it be to define the structural deficit at any given time?

If something is to go into a constitution, its meaning must be both clear, and constant.

To see the sort of difficulties that might arise, one should look at a recent OECD study on Ireland(OECD working paper number 909, by David Haugh published 2 December 2011). It said

*“Rules specified in terms of cyclically-adjusted balances or equivalently balances measured “over the cycle” are difficult to operationalise and monitor because they depend on forecasting the size of spare capacity in the economy, which cannot be observed and is particularly difficult to estimate for a small open economy such as Ireland’s.*

*The Swedish Fiscal Policy Council found it difficult to assess compliance with the government’s target of a 1% surplus over the cycle (Calmfors, 2010).*

*Disputes over when the cycle started and finished were among the most contentious aspects of rule that operated in the United Kingdom until the end of 2008 (OECD, 2009).*

*Reliance on such measures may also induce policy mistakes. With the benefit of hindsight, initial cyclically-adjusted fiscal balance measures appear to have given an overly optimistic view of the Irish fiscal position prior to the crisis, which may have contributed to a sharp rise in expenditure in 2007 before the crisis hit”*

If economists in the OECD have difficulty with this concept of a structural deficit , as indicated in this quotation, one must wonder what the judges of the Irish Supreme Court will make of it.

My understanding is that economists often radically revise their opinion, afterwards, about what the structural deficit really was in a previous year. That would make life very difficult for the Supreme Court!

While the European Court will verify the transposition of the new 0.5% rule at national level, it will be the Irish and other national Supreme Courts that will have the job of interpreting it. If something like this is written into the Constitution, the ultimate decision on whether a budget for any given year is compliant with the constitution will have to be made by the judges of the Supreme Court. This certainly will bring judges into areas of judgement which are not, to put it mildly, their primary expertise.

There is also the question of what sanctions the Supreme Court could impose, if a structural budget deficit exceeds 0.5% of GDP .

As far as I know, some countries, like France, have relatively soft sanctions for breaching the constitution, while other countries, like Ireland, immediately strike down as null and void, something that is unconstitutional. It may seem fanciful at this stage, but one also has to ask what would happen if Britain, which has no written constitution at all were to join the Euro at some future time?

When is this new arrangement to come into force?

If the provision is intended to influence the markets, the date cannot be pushed too far into the future. The Commission is to propose a calendar for this. Will it be the same calendar for all members, or will countries with the biggest structural deficits get more time?

According to NCB, even if we follow all of the plan, Ireland's structural deficit will still be at 3.7% in 2015, which is well above the 0.5% to be written into our constitution.

According to Deutsche Bank, the structural deficit of the Euro area as a whole stood at 3.2% in 2011, so the rest of Europe has a long way to go too.

I believe this particular proposal needs to be teased out , rigorously and in great detail, and I have no doubt the Irish Government will be doing that in the next few months.

A LIFESTYLE CHANGE MAY NOT BE ENOUGH, THE PATIENT MAY ALSO NEED EMERGENCY TREATMENT!

As I said earlier, the ageing of our populations requires us to follow the path laid out in the fiscal compact.

Keynes General Theory was formulated for a society with a very different demography than the one Europe has today. That is why we have no choice, euro or no euro, but face up to the fiscal challenge posed by the statement of the EU Heads of Government of the 9 December.

But, as I have said, we need to get the details right.

In the meantime, the ECB must act as a normal Central Bank and provide liquidity for the markets. The risk now is of destructive deflation, not of inflation. Germans may want to protect their savings, but they also need incomes, and their incomes will disappear if the European economy collapses.

I hope Chancellor Merkel understands that, and does not stand in the way of emergency treatment of the economy by the ECB.

Lifestyle changes are important and necessary, but the patient needs to be alive, if he or she is to change lifestyle!

It is also important that, now that the concept of the economic cycle is to be introduced into our constitutions, we do not pursue unnecessarily procyclical policies. Some have argued, convincingly, that the Basel Three rules, as applied to banks, are unnecessarily procyclical. They are dealing with yesterday's problem, excessive exuberance, which the markets are punishing sufficiently anyway.

The Summit did not address the banking problem at all, and this is a pity. The difficulties of banks are at the heart of the problem. Society needs banks, and some banks are well worth saving, because banks are the repositories of our savings, and the engines of our economy

But Martin Wolf was right when he wrote in the "Financial Times" last March "The German Government should tell their people that they are rescuing their own savings under the guise of rescuing peripheral countries".

I do not have the sense that that has happened yet, and that is why the 9 December Summit is not the final word on the crisis.