Opening Remarks of Prof. Karl Whelan (University College Dublin) at Oireachtas Committee on European Affairs. February 2, 2012

Economists have long debated the question of whether macroeconomic policy should be set on the basis of a pre-specified set of rules or whether policy-makers should be allowed discretion to set policy as they see fit. Personally, I am a sceptic regarding legally-binding macroeconomic rules.

As a professional macroeconomist, I think it is important to admit the limits of our knowledge. Governments can face policy challenges that even the most complex rules may fail to anticipate. And we should also acknowledge that our understanding of how the macroeconomy works is, at best, incomplete and economists are often one step behind in figuring out how things work.

For these reasons, macroeconomic rules that constitute "frontier macroeconomic thinking" at one time can end up being viewed later as overly rigid and outdated. The adherence of international policy makers to the Gold Standard during the 1930s provides a good example.

What is noteworthy about the new EU Fiscal Compact, however, is that it does not correspond to mainstream thinking among economists as to how an ideal fiscal policy framework should operate.

I suspect most economists would agree that such a framework should have two key elements.

First, it should guide an economy towards a moderate and sustainable level of public debt.

Second, it should keep public debt fluctuating around this moderate level in a counter-cyclical fashion, with higher-than-usual deficits in times of recession being offset by improvements in the fiscal position during expansions.

This ability to allow counter-cyclical movements in fiscal policy should be particularly important in areas that do not benefit from centralised federal government transfer programmes or have the ability to set their own exchange rates or interest rates.

In relation to the first element, moderate debt levels, the compact echoes the already-existing "six-pack" in emphasising the need for an explicit trajectory whereby countries can return towards a 60 per cent debt-GDP ratio. I think this addition to the Stability and Growth Pact is a positive one and one could make an argument for placing this rule on formal EU-treaty footing.

However, the key innovation in the compact is the so-called "golden rule" setting a maximum structural deficit of a half per cent of GDP when a country has a debt ratio above 60 per cent and a maximum of one per cent when a country has a debt ratio lower than 60 per cent. In addition, independent of the "cyclical adjustments" that are factored in to structural deficits, the maximum actual deficit shall be three per cent of GDP.

The idea of the desirability of "balanced budget" may appear self-evident to its designers, embodying as it does the wisdom the famous Swabian housewife. However, an economy is not a single household and these comforting comparisons can be highly misleading.

In fact, this rule is a poor one that doesn't correspond to either of the principles of good fiscal policy just noted.

In relation to long-run debt levels, this rule, if followed over time, will lead to debt ratios well below those considered sustainable and moderate. An economy's debt-GDP ratio tends to converge towards the ratio of the average deficit size to the average growth rate of nominal GDP. With an average growth rate of nominal GDP of say, 4 per cent, following a policy in which average deficits are a maximum of 1 per cent, will lead to a maximum debt-GDP ratio of 25 per cent, well below levels that are moderate and sustainable.

These rules will also severely limit the ability to use fiscal policies for stabilisation purposes in a manner consistent with moderate long-run debt levels.

For example, a deficit of 2.4 per cent per year would stabilise the debt-GDP ratio at 60 per cent if nominal GDP grew at a 4 per cent pace. And an average deficit of 2.4 per cent could also allow for cyclical deviations of two or three percentage points without endangering fiscal stability. However, the 3 percent maximum deficit rule severely limits the ability to run counter-cyclical policies of this type that would still be consistent with moderate levels of debt.

Finally, the legal invocation of the concept of a structural deficit is unfortunate. This is a theoretical concept and empirical measures of it can differ widely depending on how the analysis is done. Legally-binding rules that rely on impossible-to-measure quantities are likely to run into trouble sooner or later.

Without doubt, the political realities of the post-EFSF European Union required a greater commitment to fiscal responsibility but Europe could have achieved this with a far better set of rules than were arrived at in this treaty.

At least those who inflicted damage on the world economy by sticking to the Gold Standard in the 1930s can claim to have been following prevailing economic thinking. The politicians who have designed these rules will have no such defence.

All that said, despite the economics of this treaty being pretty terrible, I think that, on balance, the arguments favour Ireland signing up to it. This is for two reasons:

- Ireland's debt ratio is now so high that the country is set for a long era of tight fiscal policy with limited (or perhaps no) room for counter-cyclical fiscal policy.
- If indeed, as the preamble to compact asserts, it is the case that the treaty needs to be passed to allow access to ESM funds, then this is a powerful argument for signing the treaty. Even those who believe that Ireland can return to the sovereign bond market before the end of the EU-IMF programme must acknowledge that the possibility of ESM funds now acts as a key safety net. Without this safety net, the bond market may not re-open under any conditions.

Economic policy-making rarely amounts to picking the best possible policy suggested by economic theory. In a choice between an overly-restrictive and badly-designed fiscal compact and the potential alternative of being denied funding for our fiscal deficit next year (and the more extreme possibilities of sovereign default or exit from the Euro) we should stick with the European project and hope we can work to improve its design in the future.